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WHAT'S INSIDE

AC22 REGISTRATION OPENS IN MARCH - SEE MORE INFORMATION ON P.34

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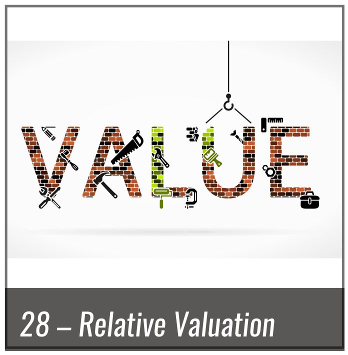


UPCOMING EVENTS

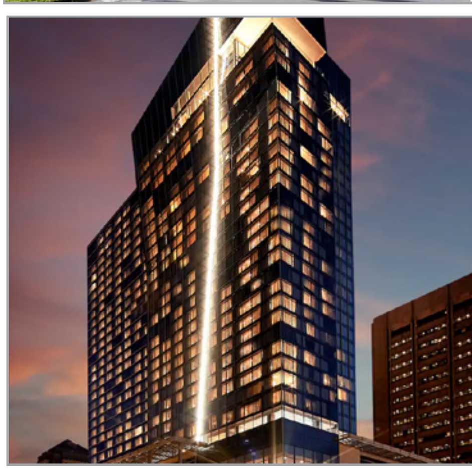
VALCON 2022

May 11-13, 2022

LOCATION:

Four Seasons Hotel, Las Vegas - Las Vegas, NV

VALCON 2022 returns as an in-person conference, featuring 10 panel sessions, case study and an ethics session about the Caesar's Bankruptcy. Featuring a Keynote Presentation by Damian Felton of The Cohen Group on International Supply Chain Issues and China. See www.abi.org for more information.



AIRA's 38TH Annual Bankruptcy & Restructuring Conference

June 8-11, 2022

LOCATION:

Hilton Cleveland Downtown Hotel - Cleveland, OH

Save the date for AIRA's 38th Annual Conference ("AC22"). The conference is planned to be held in-person. More information on p.34

From the Executive Director's Desk

JAMES M. LUKENDA, CIRA

AIRA

It's 2022 and we are off to a start that is, how shall I describe it, unpredictable? Inflation, continued health concerns, and now world conflict. There's a lot going on which will have an impact on our membership's businesses. Exactly what that impact will be is the unpredictable element.

AIRA was grateful to see a break in COVID-19 in late 2021. That breather enabled us to successfully conduct AIRA's 20th Annual New York Advanced Restructuring and Plan of Reorganization Conference as a hybrid event in November, allowing in-person attendance and on-line participation. We give a big thank you to everyone, especially our presenters and organizers. But… leave it to mutating microorganisms…we and the New York Institute of Credit were back to virtual with January's joint program.

As things have now continued to improve on the community health front, AIRA and the annual conference planning committee are moving forward with our in-person **38th Annual Bankruptcy and Restructuring Conference in Cleveland, Ohio to begin on June 8, 2022**. Registration for the conference will likely be open by the time this issue of *AIRA Journal* is available. Likewise, ABI and AIRA and the **VALCON** planning committee are hoping to see many of you in **Las Vegas beginning on May 11, 2022 at the Four Seasons**. With the health of our membership and conference participants in mind, AIRA continues to monitor the COVID-19 situation and will provide updates as necessary.

2021 proved to be a curious year from the viewpoint of business distress. As reported recently by Epiq AACER, business chapter 11 filings fell from 7,129 in 2020 to 3,725 in 2021. The level of 2021 filings was the lowest in the last 10 years, where, on average, annual business bankruptcy filings have hovered around plus or minus the mid-5,000s. In my mind, this is a clear indication that the federal stimulus funding had its intended effect. But, as reported by William Blair & Company, L.L.C., who follows the specialty consulting industry with an emphasis on restructuring, February 2022 job postings and employment metrics have accelerated for the consulting companies they follow, implying a positive outlook for specialty consulting services this year.

AIRA membership continues to have strong, active participation in AIRA's CIRA and CDBV programs. During 2021, 56 members achieved CIRA certification while three members added CDBV to their professional credentials. I congratulate them all for their achievements.

As we noted in a Membership Alert last month, the Judicial Conference of the United States released through the Federal Register on Friday, February 4, 2022, *Adjustment of Certain Dollar Amounts in the Bankruptcy Code*. Certain dollar amounts are adjusted to reflect an increase of about 10%, effective April 1, 2022 for the period through March 31, 2025, to reflect the change in the Consumer Price Index for All Urban Consumers for the most recent 3-year period ending January 1, 2022. These revisions impact various definitions in the Bankruptcy Code, certain minimums, as well as amounts of exclusions and exemptions. The revised amounts may be accessed on the AIRA website, under Membership Alerts, where there is a link to the Federal Register announcement.

As we start off this new year, my thanks go out once again to Michele, Mike, Cheryl, and Valda for all their efforts this past year on behalf of the association and you, the membership.

Another excellent series of articles follows. Stay safe and stay well.

Jim

A Letter from AIRA's President

MICHAEL R. LASTOWSKI
Duane Morris LLP

Dear fellow AIRA members:

There are signs throughout the country that the COVID-19 "pandemic" is slowly receding into the status of an "endemic." Many professional organizations have recently sponsored live events, while observing local COVID-19 restrictions. The AIRA has been part of this trend.

AIRA's 20th Annual Advanced Restructuring and Plan of Reorganization Conference was held at the Union League Club of New York on November 15, 2021. The Conference was a "hybrid" event: the online option gave all of our members, including members who reside outside of the mid-Atlantic states, an opportunity to participate. We also co-hosted the annual NYIC/AIRA Joint Bankruptcy and Restructuring event in New York City on January 19, 2022, which was an online-only event. Thank you to everyone who participated in these events.

VALCON 2022 will be a live event in Las Vegas, NV from May 11 through May 13, 2022.

AIRA's 38th Annual Conference will take place in Cleveland, OH from June 8 through June 11, 2022. You will be receiving more information about this conference in the weeks ahead, and I encourage all of you to attend. This will be a "live" event.

Many of you may have noticed the continued increase in quality and quantity of the articles that appear in the *AIRA Journal*. These positive changes are due to the good work of Boris Steffen of Province, Inc., and David Bart of Baker Tilley US, LLP, who have done a masterful job of gathering articles. We are interested in original content and in republishing articles from other professional organizations. Please let us know if you are interested in writing an article or if you would like us to republish an article. In either event, please reach out to me at mlastowski@duanemorris.com or Boris Steffen at bsteffen@provincefirm.com.

I also encourage you to take advantage of the many opportunities to participate in our conferences. Opportunities include both speaking and joining a conference planning committee. If you are interested in participating in any of our conferences, please reach out to one of our board members, all of whom are identified on our website.

Finally, AIRA continues to offer its professional certification and educational courses online. AIRA's website provides information about our CPE offerings and, of course, the CIRA and CDBV training programs are all offered online. For further information, contact our Executive Director, Jim Lukenda, at jlukenda@aira.org.

Once again, I thank you for all your support and I hope to see you at future AIRA events.

2022 COURSES

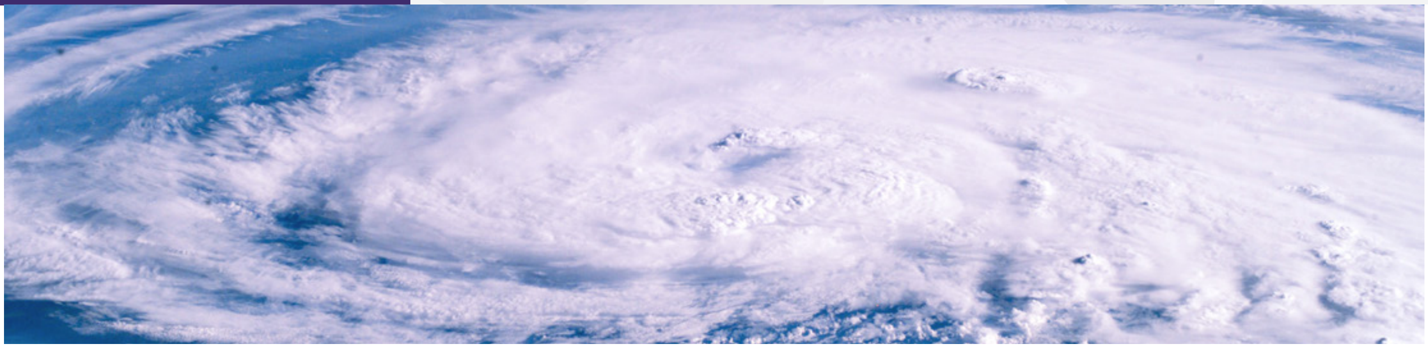
CDBV

Part:	Dates:	Location:
2	Apr 19-28, 2022	Online
3	Aug 23-Sep 01, 2022	Online

CIRA

Part:	Dates:	Location:
3	May 24-Jun 01, 2022	Online
1	Jun 06-07, 2022	Cleveland, OH
2	Jul 12-20, 2022	Online
3	Sep 06-14, 2022	Online
1	Oct 05-13, 2022	Online
2	Nov 15-17, 2022	Online
3	Dec 12-15, 2022	Online

More information and registration at www.aira.org



VALUING BUSINESS INTERRUPTION CLAIMS IN A POST-PANDEMIC WORLD

DAVID YOHAI, HEATHER WEAVER, and SHERRY SAFAVI
Weil, Gotshal & Manges LLP

Courts across the globe are flooded with business interruption insurance claims arising out of the COVID-19 pandemic, extreme weather events, cyberattacks, and other catastrophes. COVID-19 has affected nearly every business, especially wreaking havoc on those in the hospitality, travel, and entertainment industries. Natural disasters are also devastating businesses in growing numbers and are expected to worsen due to climate change. Likewise, cyberattacks are surging, causing businesses to shut down for weeks at a time. Now more than ever, business interruption insurance has proven to be a critical component of every business's insurance portfolio, with some businesses relying on the recovery of pending claims to ensure their survival.

This article discusses the challenges that COVID-19 and other recent catastrophes present when calculating business interruption claims. It surveys the two common approaches adopted by courts, examines their outsized impact on an insured's recovery, and discusses how the influx of new decisions will change the business interruption landscape. It also analyzes how the underwriting process is evolving to account for the economic impact of these recent disasters.

Courts Are Divided on Consideration of Post-Loss Market Conditions in Calculating Business Interruption Losses

Large-scale catastrophes devastate local and regional economies. Courts are split on whether to consider post-loss market conditions in calculating the insured's business interruption losses. While a major catastrophe is likely to financially depress affected areas, the impact on businesses is varied. For example, some businesses, such as hotels and home improvement retailers, may actually prosper in the aftermath of a hurricane given an increase in demand for their goods and services. This raises the question of whether such businesses should be able to recover for the increased profits they would have earned had they been able to continue operating. Alternatively, questions arise as to whether an insured's losses should be reduced if the insured would have generated minimal revenue or even operated at a loss in the post-catastrophe environment.

Courts generally follow one of two approaches: 1) the "Economy Ignored" approach, which calculates the loss as if the peril had not occurred; or 2) the "Economy Considered" approach, which calculates the loss as if the peril occurred but the insured was not damaged. Neither approach inherently favors the insured or insurer. Whether a given approach is coverage maximizing or coverage minimizing turns, in part, on the type of disaster, nature of the business, and policy language at issue. However, the court's approach can drastically impact recovery.

The Economy Ignored Approach

Under the Economy Ignored approach, courts look to pre-loss income to determine a business's expected profits in a hypothetical post-loss world where the catastrophe never occurred.

- ***Coverage Maximizing***

  In *Finger Furniture Co. v. Commonwealth Insurance Co.*,[1] the insured furniture retailer was forced to close its stores due to flooding.[2] When Finger reopened, its sales skyrocketed.[3] The insurer sought to reduce Finger's business interruption losses by its post-storm profits.[4] Rejecting this argument, the Fifth Circuit found that the policy did not allow one to "look prospectively to what occurred after the loss," requiring the loss to "be based on historical sales figures."[5]

[1] 404 F.3d 312 (5th Cir. 2005).
[2] *Id.* at 313.
[3] *Id.*
[4] *Id.*
[5] *Id.* at 314.

In *Consolidated Companies, Inc. v. Lexington Insurance Co.*,[6] the Fifth Circuit considered whether an insurer could rely on post-catastrophe market conditions to reduce an insured's recovery, since the depressed post-Katrina economy would have reduced their profits even if they had not been damaged.[7] The court again found that the jury was "not to look at the real-world opportunities for profit post-Katrina, but instead was to decide the amount of money required to place [the insured] in the same positions in which it would have been had Katrina not occurred."[8]

- ***Coverage Minimizing***

  The Fifth Circuit maintained its Economy Ignored approach with a pro-insurer holding in *Catlin Syndicate Ltd. v. Imperial Palace of Mississippi, Inc.*[9] An insured casino whose revenue spiked when it reopened before its competitors after Hurricane Katrina argued that its claim should be calculated using its higher post-hurricane sales, increasing its claim by $70 million dollars.[10] Unpersuaded, the court held that "sales figures after reopening should not be taken into account" and directed the parties to use historical sales figures to determine the loss.[11]

The Economy Considered Approach

Under the Economy Considered approach, business interruption losses are calculated based on a hypothetical situation where the peril occurred, but the insured was able to continue operating.

- ***Coverage Maximizing***

  In *Levitz Furniture Corp. v. Houston Casualty Co.*,[12] a furniture retailer that suffered flood damage sought to recover for its "lost opportunity" to benefit from increased, post-disaster consumer demand.[13] The insurer argued that business interruption coverage was designed to place the insured "in the position it would have been had no loss occurred," and, absent the flood, there would have been no increased demand for Levitz's products.[14] Favoring the insured, the court found that the policy allowed for recovery of earnings Levitz would have made "had no business interruption occurred, *i.e.*, had Levitz not been forced to shut down after the flood."[15]

- ***Coverage Minimizing***

  In *Penford Corp. v. National Union Fire Insurance Co.*,[16] flooding damaged the insured's manufacturing facility.[17] Penford sought to bar the opinion of the insurer's expert that Penford's losses should be adjusted downward to account for the effect of the 2008 recession.[18] Finding in favor of the insurer, the court held that "unfavorable market conditions" were "relevant to the question of what Penford's likely revenues would have been in the absence of the flood" as the recession would have affected Penford's earnings even if the flood did not occur.[19]

Influx of Business Interruption Cases Will Reshape the Landscape for Post-Catastrophe Damages Calculations

Recent precedent analyzing the proper method for calculating business interruption claims is limited.[20] That will soon change as courts begin to resolve the thousands of pending COVID-19 and other business interruption claims. To date, the analysis of COVID-19 claims has focused on whether insurers have an obligation to pay (*e.g.*, whether the presence of a virus constitutes a "physical loss" under the policies), not how much they should pay. Before long, in those cases that survive, courts will shift gears to focus on the value of those claims, a complex but critical process for both insurers and insureds.

The method adopted by courts in COVID-19 cases in particular, where businesses experienced extended closures and restrictions, could impact the value of a claim by tens or even hundreds of millions of dollars. This is especially true given COVID-19's major economic impact. For many businesses, the Economy Considered approach could potentially be harmful as courts could find that those businesses would have taken a financial hit even if they had continued operating given reduced consumer demand. Alternatively, a court could find that if a business had been able to continue operating without its competitors, demand would have increased due to the limited supply or access to other similar businesses.

The calculation of COVID-19 business interruption claims is further complicated by the fact that restrictions and regulations were constantly changing. As a result, the income of certain businesses fluctuated considerably based on various factors such as the season and state of the pandemic. For example, when a

6 616 F.3d 422 (5th Cir. 2010).
7 *Id.* at 430-32.
8 *Id.* at 432 (cleaned up).
9 600 F.3d 511 (5th Cir. 2010).
10 *Id.* at 512.
11 *Id.* at 516.
12 No. 96-1790,1997 U.S. Dist. LEXIS 5883 (E.D. La. Apr. 28,1997).
13 *Id.* at *6.
14 *Id.*
15 *Id.* at *8.
16 No. 09-CV-13-LRR, 2010 U.S. Dist. LEXIS 60083 (N.D. Iowa June 17, 2010).
17 *Penford Corp. v. Nat'l Union Fire Ins. Co.*, No. 09-CV-13-LRR, 2010 U.S. Dist. LEXIS 3737, at *13 (N.D. Iowa Jan. 19, 2010).
18 *Penford Corp.*, 2010 U.S. Dist. LEXIS 60083, at *28.
19 *Id.* at *31-32.
20 *See Hampden Auto Body Co. v. Owners Ins. Co.*, No. 17-cv-1894-WJM-SKC, 2020 U.S. Dist. LEXIS 206926 (D. Colo. Nov. 5, 2020); *Alley Theatre v. Hanover Ins. Co.*, No. H-19-1987, 2020 WL1650659 (S.D. Tex. Mar. 26, 2020).

Continued from p.7

national emergency was declared in March 2020, most restaurants were forced to shut down completely. Many restaurants then reopened for takeout and delivery. Eventually, restaurants were permitted to reopen for indoor dining but with varying capacity restrictions. During the warmer months, many restaurants converted their outdoor spaces to maximize business. All of these factors, which remained in flux over an extended timeframe, complicate the calculations of COVID-19 business interruption losses.

The resolution of COVID-19 claims will also affect the calculation of other types of business interruption claims. For example, courts in many jurisdictions, including those that have not yet addressed the issue, will be forced to set precedent regarding which approach to take when calculating business interruption losses. COVID-19, in general, will also affect the value of pending and future claims given its substantial economic impact regardless of which approach a court adopts. Under the Economy Considered approach, some businesses will struggle to show that their income would not have plummeted regardless due to COVID-19, while others might be able to establish a pandemic-related increase in demand for their goods or services. Under the Economy Ignored approach, COVID-19 may still affect claim calculations because recent sales data preceding the loss event could reflect atypical numbers due to COVID-19. For example, a question arises as to how the historical profits of a business affected by Hurricane Ida should be calculated if the business experienced pandemic-related supply chain disruptions and labor shortages. This raises other questions regarding whether a longer lookback period would more accurately reflect the revenue of a particular business over time, and therefore be a more appropriate business loss calculation.

Avoiding the Unknown Through Inclusion of Clear Policy Language

The COVID-19 pandemic has underscored the importance of a meaningful underwriting process and more meticulous policy drafting so that the coverage being afforded is clear and predictable. Many business interruption policies include standard language measuring the insured's recovery in terms of the insured's net income "had no loss occurred." While some courts interpret "loss" to mean the peril (consistent with the Economy Ignored approach),[21] others interpret "loss" to mean damage to the insured (consistent with the Economy Considered approach).[22]

Given these conflicting interpretations, some insurers have sought to add clarifying policy language expressly denying an insured's recovery of advantageous post-catastrophe market earnings. Such provisions, typically referred to as "favorable conditions" clauses, exclude the consideration of "any Net Income that would likely have been earned as a result of *an increase in the volume of the business due to favorable business conditions caused by the impact of the Covered Cause of Loss* on customers or on other businesses."[23] These provisions, which first became popular following Hurricane Katrina,[24] exist in many of the policies at issue in COVID-19 and other business interruption claims working their way through the courts.[25]

Few cases have addressed the impact of "favorable conditions" clauses on post-loss recovery and, thus, the pending cases will play a significant role in clarifying the law in this area. The limited cases dealing with this issue, however, have not all favored insurers.[26] Because the policy language typically requires that the favorable business conditions be "caused by" the insured peril, some courts are disinclined to apply them where the changed economic conditions are tied to other external events. For example, in *Hampden Auto Body Co. v. Owners Insurance Co.*, the court *permitted* expert testimony considering advantageous post-catastrophe profits despite a "favorable conditions" provision because the increased business demand stemmed from a series of subsequent storms and not only the storm that caused the interruption to the insured's business.[27] This raises interesting questions regarding the effectiveness of these provisions in today's environment where natural disasters are more frequent and often overlap.

In light of COVID-19 and the uptick of other disasters, insureds and insurers will be incentivized to include policy language clarifying how post-catastrophe economic conditions will affect the calculation of business interruption losses. For example, insureds may seek to exclude "favorable conditions" clauses, and instead include language that would allow recovery of any increased profits that would likely have been earned due to beneficial business conditions after the catastrophe. Insurers will likely continue to push for "favorable conditions" clauses to exclude recovery of any increased profits due to the post- catastrophe economy. Both sides may wish to ensure that their

[21] *See, e.g.*, *Imperial Palace*, 600 F.3d at 515; *Finger Furniture*, 404 F.3d at 314.

[22] *Stamen v. Cigna Prop. & Cas. Ins. Co.*, No. 93-1005-CIV-DAVIS, 1994 U.S. Dist LEXIS 21905, at *7-8 (S.D. Fla. June 10,1994).

[23] ISO Commercial Property Form, CP 00-30-04-02, H C(3)(a)(l)-(2) (emphasis added).

[24] *See, e.g.*, *Rimkus Consulting Group, Inc. v. Hartford Cas. Ins. Co.*, 552 F. Supp. 2d 637, 639 (S.D. Tex. 2011); *Berk-Cohen Assocs., LLC v. Landmark Am. Ins. Co.*, Nos. 07-9205, 07-9207, 2009 U.S. Dist. LEXIS 77300, at *10 (E.D. La. Aug. 27, 2009).

[25] *See, e.g.*, *Ramaco Res., LLC v. Fed. Ins. Co.*, No. 2:19-cv-00703, 2021 U.S. Dist. LEXIS 117249, at *56 (S.D.W. Va. June 23, 2021); *Dotexamdr, PLLC v. Hartford Underwriters Ins. Co.*, No. 3:20cv698(MPS), 2021 U.S. Dist. LEXIS 145713, at *5 (D. Conn. Aug. 4, 2021).

[26] *See Imperial Palace*, 600 F.3d at 515 (noting presence or absence of a "favorable conditions" clause "d*id* not impact" analysis); *Berk-Cohen Assocs., LLC v. Landmark Am. Ins. Co.*, 433 Fed. App. 268, 270 (5th Cir. 2011); *Hampden Auto Body Co.*, 2020 U.S. Dist. LEXIS 206926, at *8.

[27] 2020 U.S. Dist. LEXIS 206926, at *8; *see also Berk-Cohen Assocs.*, 433 Fed. App. at 270.

respective language applies regardless of whether the favorable post-loss business conditions were caused by the peril that initially interrupted the insured's business. For example, if an insured hotel is forced to shut down after sustaining fire damage, and then a subsequent hurricane increases demand for that hotel, the insured will want to make sure that it can recover those increased profits even though the fire is what caused the hotel to close. To the contrary, an insurer will want to ensure that the "favorable conditions" clause excludes recovery of increased profits regardless of whether the fire or a subsequent hurricane triggered the increased demand. It is also possible that insurers and insureds will increasingly wish to avoid the uncertainties of post-loss economic conditions altogether and agree to include policy language that would allow an insured to recover based on its historical sales data and financial performance before the loss occurred. To ensure further predictability, the parties may seek to define the lookback period in the policy so that there is no debate as to the timeframe that should be considered in calculating losses. These are just a few ways that insurers and insureds can manage expectations and clarify coverage on the front-end to avoid unforeseen circumstances arising out of major crises such as COVID-19 and other recent disasters.

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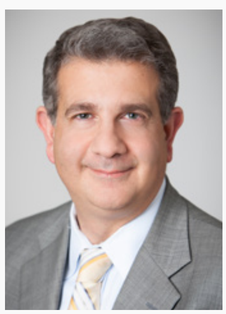

David Yohai is partner in Weil's Complex Commercial Litigation practice and Co-Head of Weil's Insurance Litigation practice. He has over two decades of experience trying and litigating commercial cases, including the successful defense of numerous jury trials with hundreds of millions of dollars at stake, and in conducting major arbitrations. David has represented both policy-holder corporates and some of the largest insurance and re-insurance companies in the world in high-profile insurance litigation and arbitration.

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Weil law clerk Sherry Safavi, who is not yet admitted to practice in New York, contributed to this article.

PRESTO CHANGE-O: UNWINDING TRANSACTIONS IN THE FACE OF UNCERTAINTY – IT'S ALL ABOUT THE RESCISSION DOCTRINE[1]

KEVIN M. JACOBS and LEE G. ZIMET

Alvarez & Marsal

If 2021 has taught us anything, it is that neither the economy nor the tax law is stable and that any Congress may seek to drastically alter the tax laws, as opposed to such a change being made "once a generation." As a result, companies have been actively engaging in transactions, including restructuring their operations, based on what they are anticipating will occur. However, when the dust settles, some taxpayers are having buyer's or seller's remorse and wishing they did not engage in a transaction. To address some of those concerns, companies should be aware of the rescission doctrine and its potential uses. Generally viewed as a last resort, the rescission doctrine may allow companies to retroactively unwind a transaction they have entered into, as long as they are aware of the open questions and potential limitations attached to this course of action.

History of the Rescission Doctrine

Neither the Internal Revenue Code nor any Treasury Regulations describe the rescission doctrine, but its genesis and application in the tax realm can be traced to *Penn v. Robertson*.[2] In that case, Charles A. Penn was a vice president and director of the American Tobacco Company (ATC). In 1929, the company directors passed a resolution that resulted in the sale of 10,000 shares of ATC stock to Penn in exchange for a note, in which dividends on the stock would be credited to the note. In 1931, in response to litigation, the directors of ATC passed a resolution to rescind and cancel the 1929 sale and the dividends that were credited in 1930 and 1931. The court, based on annual income tax accounting, required Penn to recognize dividend income with respect to the 1930 dividend, but allowed the rescission of the 1931 dividend.

Forty years later, in Revenue Ruling 80-58,[3] the Internal Revenue Service acknowledged that rescission could be accomplished by mutual agreement, by one party's declaration of rescission of the contract without the other's consent if sufficient grounds exist, or by court order. However, the IRS required that:

- the parties to the original transaction are the same parties that entered into the rescission;
- the parties be returned to the "relative positions that they would have occupied had no contract been made"; and
- the rescission and restoration occur within the same taxable year as the original transaction.

It is important to note that, in formulating these requirements, the IRS did not refer to a nontax business purpose in order to apply the rescission doctrine. In fact, the IRS has issued numerous private letter rulings allowing taxpayers to rescind a transaction in order to obtain a better tax result or to correct a tax error, including:

- unwinding a liquidation or merger to restore the shareholder's basis in the stock of the liquidated entity or to address uncertainties about the tax consequences of the transaction;
- unwinding a sale so that it can be structured as a qualified stock purchase to which a Section 338(h)(10) election can be made;
- unwinding the satisfaction of debt using corporate stock to adjust the amount of debt satisfied, with the remainder being cancelled via a capital contribution; and
- unwinding the transfer of an S corporation so that its suspended losses are not eliminated.

These rulings are significant in that they have not only allowed taxpayers to rescind a transaction solely for tax reasons but also essentially offered taxpayers a mulligan that allows them to recast a previously agreed-upon transaction. In other words, mere rescission would involve undoing a transaction, whereas a mulligan allows the taxpayer to undo a transaction and reengage in a modified form of the same transaction.

Taxpayers should be aware that the IRS no longer issues private letter rulings on rescissions and that it may no longer support some past rulings.[4] Additionally, the courts and the IRS generally do not allow for rescission

[1] This article is a revised version of an article that originally appeared in the November–December 2021 issue of *Tax Executive*, the professional journal of Tax Executives Institute, and is reprinted with the permission of TEI and the authors. Kevin M. Jacobs and Lee G. Zimet, "Presto Change-o: Unwinding Transactions in the Face of Uncertainty," *Tax Executive*, Nov.–Dec. 2021, at 25, https://taxexecutive.org/presto-change-o-unwinding-transactions-in-the-face-of-uncertainty/.

[2] 115 F.2d 167 (4th Cir. 1940).

[3] 1980-1 C.B. 181.

[4] Revenue Procedure 2021-3 Section 3.02(8).

if the transaction involves stock that post-transaction, but pre-rescission, declared a dividend that created an irrevocable vested legal right to the payment.[5]

The Returning-Parties-to-the-Same-Relative-Position Requirement

The concept of returning taxpayers to the same relative position they would have occupied if the underlying transaction were never entered into seems relatively straightforward. The rescission must involve the same parties and the same property. However, several nuances must be explored, because this requirement has not been strictly applied. For example, if a taxpayer sells property for cash, a strict interpretation would require the taxpayer to return the cash in exchange for the property in order to qualify for the rescission doctrine. Nonetheless, several courts have held that the rescission doctrine applies even if the taxpayer issues a note instead of returning the underlying cash. Additionally, the application of the rescission doctrine does not appear to require the taxpayer to compensate the buyer for the use of its cash between the time of the transaction and the rescission. Therefore, the taxpayer, in essence, has received an interest-free loan from the buyer.

Another nuance that taxpayers should be cognizant of is the potential application of the doctrine in the case of a partial rescission, which occurs when the parties want to rescind a portion of the transaction rather than the entire transaction. But very little guidance exists concerning what requirements a taxpayer must satisfy to engage in a partial rescission. That said, in the few instances where the courts and the IRS have permitted a partial rescission, the following additional requirements appear to have been imposed:

- the original transaction could be clearly bifurcated into the portion of the transaction that would remain and the portion that was rescinded, and
- the parties clearly intended to engage in a partial rescission.

However, it is worth noting that some courts have held that a partial rescission may not be eligible for the rescission doctrine.[6]

The Same-Taxable-Year Requirement

Like the returning-to-the-same-relative-position requirement, the same-taxable-year-requirement seems relatively straightforward. But does one determine the applicability of the doctrine if the parties to the original transaction have different taxable years? For example, assume that on May 1, 2021, seller S, a calendar-year taxpayer, sells a building to buyer B, whose fiscal year ends on March 31. On August 1, 2021, the parties want to rescind the sale. Would that satisfy the same-taxable-year requirement? August 1 occurs within the same taxable year of the sale for S but in a different taxable year for B. These situations demand caution, since there is limited guidance on this issue, and the answer may depend on what consideration B transferred. In other words, if B transferred cash, then trying to rescind on August 1 may allow the rescission doctrine to apply. However, if B transferred property, then trying to rescind on August 1 may not allow the doctrine to apply, because in addition to being a buyer of the building, B was also a seller of property. It may be possible that the rescission may be valid for S but not for B, but again it is important to look at all of the underlying facts and consult with a trusted advisor when making that determination.

What Happens Now?

If the rescission doctrine does in fact apply, then it is treated for tax purposes as if the underlying transaction never occurred. For example, if on July 9 seller S sells depreciable property that it purchased in the prior year to buyer B, and the transaction is subsequently rescinded on November 9, then S is entitled to a full year's worth of depreciation deductions because it is deemed to have held the property for the entire year on account of the rescission. This rationale applies to full and partial rescissions. However, multiple dates can be involved in a transaction if the rescission is also part of a change of the terms (that is, a renegotiation of the original transaction). In those cases, the IRS has ruled that the rescission nullifies the original transaction, and the new transaction is treated as occurring on the date it was entered into (that is, not the date of the original transaction).[7] This treatment, however, could become more complex in a partial rescission: Is it treated as if the taxpayers entered into two different agreements, or are the two viewed as part of a plan and therefore treated as being entered into on the same day?

Revoking a Check-the-Box Election

Another option taxpayers should be aware of is the potential ability to withdraw a check-the-box election. In general, many business entities are permitted to choose or change their entity classification for US income tax purposes by making a check-the-box election. However, unless the election is made effective as of formation (or, in the case of foreign entities, as of the date it is first relevant), an entity may generally make only one election in a five-year period. In the absence of an election, the taxpayer retains its default classification, as determined under the applicable Treasury Regulations.[8]

5 See, for example, *Crellin's Estate v. Comm'r*, 203 F.2d 812 (9th Cir. 1953), *cert. denied*, 346 US 873 (1953).

6 *See*, for example, *Estate of Kechijian v. Comm'r*, 962 F.3d 800 (4th Cir.).

7 *See*, for example, Private Letter Ruling 201211009.

8 Treasury Regulations Sections 301.7701-2 and 301.7701-3(b).

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There may be situations where an entity (foreign or domestic) files a check-the-box election but later regrets having done so. Even if the entity is permitted to file a new election to change its classification, the choice is not retroactive and thus cannot unwind the effects of the original election. However, the IRS provides relief whereby, under certain circumstances, the IRS may allow a taxpayer to withdraw a check-the-box election.[9]

Specifically, a taxpayer may withdraw a previously filed check-the-box election if it initiates the process by the due date of the tax return for the taxable year in which the election was effective. It is unclear whether extensions are taken into account for this purpose. If the process applies, the entity returns to its pre-election classification status and is eligible to make a new check-the-box entity election (with the effective date based on the new election). Even if the taxpayer does not initiate the process by the due date of the initial tax return, it may be possible for a taxpayer to apply to have the tax status of the entity returned to the default status. However, there is uncertainty as to how this process applies.

Companies are strongly encouraged to work with a trusted advisor to determine their eligibility for this withdrawal relief.

Conclusion

Taxpayers always try to structure tax-efficient transactions. However, changing circumstances, including a potential change in law, may render previously well-reasoned and tax-advantageous transactions rather costly. The potential applicability of the rescission doctrine to unwind a transaction or potentially undo a check-the-box election may alleviate some of the distress associated with those changes in circumstances. The potential application of the rescission doctrine is a facts-and-circumstances determination. As a result, companies considering whether they may be eligible for relief are advised to consult with a trusted advisor as soon as possible, because when it comes to the potential application of the rules for undoing transactions, timing is crucial.

[9] Internal Revenue Manual 3.13.2.27.9 (January 1, 2022). However, the ability to withdraw a check-the-box election may not always be automatic. *See*, for example, Private Letter Ruling 202123001.

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NAVIGATING CHINA'S RECENT REGULATORY REFORMS

BEN YEUNG and SCOTT MCKAY

J.S. Held

Introduction

In recent months, Chinese financial industry and cybersecurity regulators have "cracked down" on overseas IPOs, enforced antitrust policies against lauded national champions, including Tencent and Alibaba, and banned for-profit private tutoring and online gaming, with a focus on minors. These efforts have led to confusion and anxiety among foreign investors, producing headlines such as "Is It Time to Avoid Investing in China?"[1] and "Goldman Clients Are Asking if China's Stocks Are 'Uninvestable.'"[2] Also, highly-leveraged Chinese developer Evergrande is teetering on the brink of collapse, while other indebted Chinese developers are having difficulties making loan or interest payments, leading to speculation around "China's Lehman Moment."[3] For long-time China watchers, these developments are not entirely surprising, but rather constitute predictable responses to long standing issues within China's economy and society.

What Is Taking Place

The economic model that has served China well for decades, characterized by suppression of domestic consumption, high levels of investment, and export-led manufacturing, is no longer considered optimum at this stage of the country's development.

Under the old model, Chinese central government planners chose pre-determined annual GDP targets in the interest of growing the total size of the Chinese economy and realizing specific developmental milestones as part of "five-year plans." Essentially the central government attempts to set GDP growth targets and earmarks specific investment subsidies to bolster certain industries, based on the data available to central government planners. Provincial and local governments then attempt to meet or exceed those targets, and local and provincial-level officials are measured on their performance along these metrics. Local governments have funded their operations and local development in two key ways, firstly by selling land to real estate developers or other firms and, secondly, by setting up local government financing vehicles (LGFVs).[4] These LGFVs act as investment companies that sell a form of municipal bonds to finance real estate, infrastructure, manufacturing, or heavy industry in the region. Local governments then repay the LGVFs from the proceeds of local investments they have made.

This old model of investment has led to high levels of debt in the Chinese economy as well as overcapacity, creating a drag on investment, not to mention excess levels of pollution, wasted natural resources, and other social issues.

Chinese central government planners are acutely aware of the limitations of this model and are now trying to balance difficult trade-offs to create an environment conducive to sustainable long-term growth. Some of the most significant challenges include: (1) preventing the country from falling into a "middle-income trap," by reforming the country's regulatory institutions and redirecting investment to areas that its leadership believes will help China ascend the value chain and become a mature economy; (2) phasing out carbon-intensive production and moving towards a carbon-neutral economy; (3) addressing the problems of an ageing workforce; (4) tackling high levels of inequality among Chinese citizens and related discontent; and (5) facing an increasingly confrontational geopolitical climate.

1 George Magnus, "Is It Time to Avoid Investing in China?" *Financial Times,* September 23, 2021, https://www.ft.com/content/fe0e9427-0cea-4421-9e14-ab382d3d8929.

2 Farah Elbahrawy, "Goldman Clients Are Asking if China's Stocks Are 'Uninvestable,'" *Bloomberg,* July 29, 2021, https://www.bloomberg.com/news/articles/2021-07-29/goldman-clients-are-asking-if-china-s-stocks-are-uninvestable.

3 Kaelyn Forde, "Is the Evergrande Meltdown China's Lehman Brothers Moment?" *Al Jazeera* online, last modified September 23, 2021, https://www.aljazeera.com/economy/2021/9/21/is-the-evergrande-meltdown-chinas-lehman-brothers-moment.

4 James Kynge and Sun Yu, "Evergrande and the End of China's 'Build, Build, Build' Model," *Financial Times*, September 21, 2021, https://www.ft.com/content/ea1b79bf-cbe3-41d9-91da-0a1ba692309f.

Why This Is Happening Now

In many ways, China is experiencing growing pains typical of an emerging economy that has relied on a combination of state capitalism and high debt to finance its transition from a poor country to a middle-income country. This model has provided above-average growth rates and materially improved the lives of a sizeable portion of the country, all while turning China into an export powerhouse with impressive infrastructure. However, these efforts have also generated widespread economic, social, and environmental problems that cannot be resolved without concerted, determined, and top-down policy measures.

Problems with the "Old Model"

Under the old economic model, local governments relied disproportionately on supporting investments in real estate, infrastructure, and heavy industry to meet their GDP targets, as "growth" in these areas is significantly easier to organize than capital-intensive industries such as precision manufacturing.

At lower levels of economic development, investments in factories; housing estates; and roads, railways and other physical infrastructure all generate immediate benefits, providing jobs, housing and services to workers and firms. However, the marginal utility of each such investment decreases with time.

As China's economy has grown in complexity and sophistication, it has become increasingly difficult and expensive for local governments and state-owned enterprises (SOEs) to foster productive investments and meet the headline GDP growth rate, as it is easier to transition from a low to moderate level of development than a moderate to high level of development. This is why mature economies grow at rates of between one and three percent per year, rather than the impressive "catch-up growth" rates possible in developing economies.

Moreover, roads, railways, bridges, and underutilized real estate not only consume resources and energy and generate pollution while under construction, but also cost money to maintain. Without sufficient demand to justify their construction, road and railway networks become a drain on the operating companies that need to be written off somewhere in the economy, by a local or provincial government or by the majority state-owned financial system. Under the old model of growth, the country has seen a real estate asset bubble and high levels of debt, reaching an estimated 290% of GDP in the third quarter of 2020 according to data from the Bank of International Settlements.[5]

Equally worrying for central planners is the risk of off-balance sheet liabilities. The exact size of these liabilities is unclear, but economists at Goldman Sachs recently estimated that total debt of LGFVs rose to around RMB 53 trillion (USD 8.2 trillion) by the end of 2020, a figure equivalent to 52% of Chinese GDP.[6] This off-balance sheet activity has been made possible by a lack of oversight, the limitations and incentives of the Chinese financial system, and wrongdoing on the part of some local government officials. Accordingly, the cost of servicing high levels of debt will either squeeze out funding for productive investments, or interest rates will have to drop to reduce the burden on borrowers.

"Gently" Deflating the Real Estate Bubble

The recent case of Evergrande and the ensuing market contagion speaks to the emergence of China's housing bubble in recent years. This has taken place as Chinese households, which have few investment options, have poured their savings into real estate investments in the belief that housing prices can only go up. Many Chinese now "own" two or more apartments that remain under construction and which have been purchased with high levels of debt. Chinese regulators have long hoped to gradually deflate the property market bubble in their quest to reduce overall leverage in the Chinese economy, but need to do so without threatening the hard-earned savings of ordinary Chinese families and causing social instability, one of the central government's biggest fears.

Previous leaders have chosen to "kick the can down the road" rather than deal with the problem head on; however, the current generation of leadership has shown greater courage in tackling long-standing, interconnected issues related to the old model. Policymakers are now seeking to maintain a balancing act by curbing wasteful real estate investment without producing excess strain on the broader financial system or generating significant social unrest. This may undermine investor sentiment in the short term but this factor is generally understood in China as a price that must inevitably be paid.

Ideological Factors

There are also ideological factors underpinning recent policy moves in China. The Communist Party of China has arrived at the 40-year mark of reform and opening up, which began in 1978. China believes that it has achieved its goal of eradicating abject poverty and creating high levels of material wealth in the economy as a whole. Nevertheless, for China's socialist transformation to be realized, the Chinese Communist Party now seeks to build a "modern socialist country that is prosperous,

[5] Yen Nee Lee, "These Charts Show the Dramatic Increase in China's Debt," *CNBC* online, June 28, 2021, https://www.cnbc.com/2021/06/29/china-economy-charts-show-how-much-debt-has-grown.html.

[6] "China's Hidden Local Government Debt Is Half of GDP, Goldman Says," *Bloomberg News*, September 28, 2021, https://www.bloomberg.com/news/articles/2021-09-29/china-hidden-local-government-debt-is-half-of-gdp-goldman-says.

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strong, democratic, culturally advanced, harmonious and beautiful."[7] To achieve this, China's leadership has begun emphasizing themes such as "common prosperity" (by which is meant a prosperity shared by all rather than a small number of people profiting enormously at the expense of the masses), and the protection of the interests of laborers, consumers, and small-to-medium enterprises (SMEs).

The "German Model"

Some commentators have suggested that state media discourse is promoting a so-called "German model" of development after losing enthusiasm for an American model. The Chinese leadership's understanding of the American model, which provided the main inspiration for the last generation of leaders, is characterized by a market-driven economy with relatively limited government intervention, and greater attention given to the needs of capitalists than the needs of workers and ordinary households. Given the various problems in the economy and observation of problems in the United States since the Global Financial Crisis, the Chinese leadership now believes the American model is also characterized by concentration of power among a few large corporations and major institutional investors, a significant social and financial gap between the rich and the poor, and exploitation of consumers and workers.

In contrast, the German model is seen to be one in which the government actively intervenes to ensure sustainable development of SMEs, relatively strong governance standards for large corporations, space for high-value manufacturing, and adequate protections for workers and consumers to prevent the pernicious effects when markets and capital are allowed to operate in an unrestricted manner.

Made in China 2025

One document that demonstrates the Chinese leadership's preference for the German model is the Made in China 2025 ("MiC 2025") plan, published in 2015. This document was loosely modelled on Germany's "Industrie 4.0" high-tech strategy, which aims to promote the computerization of German manufacturing.[8] MiC 2025 outlines ten industries that the Chinese government has identified as industries of the future, as well as specific goals and market shares that it hopes to achieve by 2025.[9]

Given the exceptionally ambitious targets for global market share under MiC 2025 and Chinese industrial subsidies, there was considerable pushback against the policy internationally, especially from the United States. The Chinese government has since downplayed the significance of the targets in public; however, the central government is still committed to achieving high-end manufacturing and stated that it will not allow manufacturing to fall as a share of GDP. This, in turn, means that China's leadership is now paying less attention to growing the services sector. The recent focus on workers' rights is an outgrowth of this, as is the discussion of nurturing a culture of "craftsmanship" of the kind seen in Germany.

Geopolitics

Chinese relations with the United States have been exceptionally strained in recent years. While the MiC 2025 strategy is one component of this, there is a broader set of factors undermining that relationship. During the Trump administration, the US government introduced heavy tariffs on Chinese imports, implemented sanctions targeting Chinese enterprises and individuals, and ordered the closure of the Houston consulate, to name just a few actions.

Other measures by the US and its allies have alerted the Chinese leadership to prepare to be cut off from Western supply chains, supplies of energy resources, or even food supplies. This has led to a greater emphasis on achieving technological independence in critical industries seen as necessary for future growth.

Meanwhile, many in China have seen the United States' repeated failure in addressing domestic problems – such as wealth disparity, social and political divisions, gun violence, and healthcare, as well as the withdrawal from Afghanistan – as signs of significant structural issues within the American model of development. All of this has reinforced Beijing's confidence and willingness to forge its own path of growth and development.

Recent Regulatory Reform

Meanwhile, Chinese leaders also recognize that the same economic model that led to impressive growth in the country had produced widespread fraud, corruption, wasted investment, and environmental degradation. It also allowed massive inequality at the individual level, the growth of an enormous real estate bubble, and a small number of firms to generate vertically and (more problematically) horizontally integrated monopolies.

In the case of technology giants such as Alibaba and Tencent, China's tech "unicorns" have collected massive troves of data on Chinese consumers and relied on big data, AI, and algorithms to attempt to control what individual Chinese consumers choose to buy. There is widespread popular resentment among ordinary Chinese people about these issues. The Chinese

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7 Zichen Wang, "The 'Spirit' of the 5th Plenum 五中全会精神," Pekingnology, 25 February 2021, https://pekingnology.substack.com/p/the-spirit-of-the-5th-plenum-

8 This idea was first introduced in 2011 and 2012, and produced a set of Industry 4.0 implementation recommendations to the German federal government. For reference, the German plan calls for customization of products, highly flexible mass production, and automation.

9 Editor's Note: For a summary of MiC 2025, see, for example, Congressional Research Service, "Made in China 2025" Industrial Policies: Issues for Congress, updated August 11, 2021, https://crsreports.congress.gov/product/pdf/IF/IF10964.

government also worries about the potential for this data to be abused by the companies themselves or by foreign governments.

One other problem weighing on government policy planners is the country's looming demographic challenges. In 2015, the Chinese central government abandoned the one-child policy in place since 1982 and allowed couples in urban areas to have a second child. This was increased to a three-child policy in 2021. To date, there are no signs that these policies have resulted in a baby boom. The Chinese leadership is therefore seeking to address the factors that are inhibiting family formation and preventing couples from having more children.

Current Chinese regulatory reforms are multi-pronged to address these collective problems from a variety of angles, with the most visible ones being:

1. Reducing systemic financial risks — In addition to the reforms targeting the real estate sector, Chinese regulators are forcing Alibaba's fintech arm, Ant Group, to restructure, with the view to separating the linkage between the market-dominant payment platform Alipay and its other businesses. The restructuring, which is being overseen by China's central bank, will transform Ant into a separate financial holding firm.[10] This move aims to differentiate between financial and non-financial firms in an effort to prevent the growth of new off-balance sheet risks. The linkage between Alipay and Ant's other businesses was also viewed as problematic by regulators, due to the massive trove of consumer data that was being amassed regarding user activity across platforms and could be used to offer financial services such as loans and investment products. There is also an important symbolism with this move, as it demonstrates that the largest companies also have to play by the same rules.

2. Anti-trust behaviour – A separate crackdown on anti-competitive behaviour is being led by the State Administration for Market Supervision (SAMR), the agency which regulates all market participants. This includes traditional anti-trust regulation, such as fines for illegal M&A that the SAMR is very experienced at enforcing. In the future, it will likely expand to include technology-driven anti-competitive behaviour such as differential pricing and the regulation of algorithms more generally (the latter also involving China's internet watchdog).[11] SAMR has considerable experience with traditional investigations into anti-competitive behaviours such as irregular M&A activity and improper pricing, for example:

- *Improper pricing* – In early March 2021, SAMR fined five Chinese group-buying platforms a maximum penalty of RMB 1.5 million for improper price competition practices, focusing on the use of subsidies. Firms that received the fines included group-buy platforms backed by Didi, Pinduoduo, Meituan and Alibaba.
- *Abuse of market position* – SAMR imposed a USD 2.75 billion fine on Alibaba in April 2021 for its alleged forcing of vendors to use its platform exclusively. In August 2021 SAMR also listed additional prohibited behaviours in which firms may not engage. These include producing misleading publicity and information about competitors, and the use of "excessive pop-up windows," amongst other matters.[12]
- *M&A irregularities* – SAMR had imposed 22 fines on several of China's major technology firms — including Alibaba, Tencent and Didi — over irregularities related to M&A deals completed over the past decade.

***3.* Data and network security** – The Cyberspace Administration of China (CAC) has been reviewing mobile applications for years and taking them offline for non-compliance. It has recently become more powerful and will likely continue to remain so, having been empowered by several important recent legislations:

[10] Reuters and Tony Munroe, "China Extends Crackdown on Jack Ma's Empire with Enforced Revamp of Ant Group," *Reuters*, 12 April 2021, https://www.reuters.com/business/chinas-ant-group-become-financial-holding-company-central-bank-2021-04-12/.

[11] Tracy Qu and Zenmei Shen, "Beijing Drafts Rules to Rein in the Algorithms Used by Big Tech to Push Videos and Popular Apps in Widespread Crackdown", *South China Morning Post*, 27 August 2021, https://www.scmp.com/tech/big-tech/article/3146680/beijing-drafts-new-rules-tame-recommendation-algorithms-latest-push.

[12] Lucas Niewenhuis, "China Steps Up Antitrust Campaign with New Draft Rules Targeting Internet Companies," *SupChina*, 17 August 2021, https://supchina.com/2021/08/17/china-steps-up-antitrust-campaign-with-new-draft-rules-targeting-internet-companies/. Selina Xu and Chika Mizuta, "China Targets Mobile Pop-Ups in Latest Tech Crackdown," *Bloomberg*, July 28, 2021, https://www.bloomberg.com/news/articles/2021-07-28/china-targets-mobile-pop-ups-in-latest-tech-crackdown.

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- *The 2017 Cyber Security Law* – This law relates to how data is acquired and stored. This was the primary law used to justify intervention in the case of DiDi's overseas IPO listing.
- *The Data Security Law* – This law came into effect on 1 September 2021 and focuses on the regulation of data from a national security perspective.
- *The Personal Information Protection Law* – This set of laws is broadly analogous to the European General Data Protection Regulation (GDPR), though recent announcements suggest that it will also regulate other types of activity, such as the use of algorithms. If implemented as outlined, this set of regulations would place China at the forefront of personal data protection and regulation globally. The Personal Information Protection Law took effect 1 November 2021.

4. **Crackdown on the "disorderly expansion of capital"** – Finally, Chinese regulatory authorities have intervened in a number of areas of the economy that may at first glance appear unrelated, but which are seen by the Chinese leadership as having a negative effect on society, legal and regulatory compliance, and/or growth. These areas have been described as "disorderly expansion of capital" in several policy documents and in state media. Some recent examples include the education sector – which state media has long criticized for being heavily profit driven and burdening ordinary Chinese households, disrupting the broader education and growth goals of the country – and companies seeking to list overseas due to a desire to avoid complying with domestic regulations. This category also relates at times to business practices believed to exploit workers, such as delivery personnel. Many of the areas targeted by this set of regulations have grown rapidly and enormously throughout the past two decades and were relatively underregulated, at least as compared with their counterparts in other countries.

From the perspective of the *laissez-faire* economic tradition in countries such as the US and UK, these measures may be either perplexing or counterproductive. However, from the perspective of the Chinese leadership and much of the populace, such interventions are overdue, and a bitter medicine required to realize sustainable economic goals.

How Investors Should Re-think China

For international investors considering an investment or additional investment in China, it is important to keep in mind certain factors specific to the Chinese business environment:

1. **Despite recent decades of spectacular growth and high-profile technological accomplishments, China remains a developing country with many issues hindering that development**. Confusing and contradictory regulations set by different regulatory fiefdoms and regulatory experiments are par for the course, as a sustainable regulatory framework with (more or less) fair rules for all market participants is in the process of being realized. While this process will involve trial and error, pushback, and discrepancies between theory and implementation, China's leadership has the advantage of acting without the need to develop a political consensus and can take a more reflective and long-term view towards systemic issues since Beijing is not constrained by partisan struggles.

2. **As in the case of many emerging and frontier markets, reliable information is more difficult, and in some cases impossible, to come by**. This difficulty is further compounded in the case of China, where Western sources are often inclined to focus predominantly on negatives and Chinese sources are inclined to focus on the positive. Understanding where to access information, and the nuance of information, is mission critical for any investor in China.

3. **China is — to a degree that is unique — a "strong state" market environment, where the direction set**

by the central government does have a significant bearing on the types of projects in which private firms choose to invest. Chinese firms are accustomed to carefully monitoring the details of five-year plans and adjusting their investments accordingly. To remain competitive in the Chinese market, investors must also keep abreast of state-led industry trends and be aware of areas likely to fall afoul of regulators due to security, political or social concerns. As has been demonstrated in recent months, going forward, data security and semiconductor independence are to remain as significant matters for the Chinese leadership – in the same way that they will be for the leaders of many Western nations.

Conclusion

Doing business in China is very different from doing business in investors' home markets, and it is imperative that would-be investors understand clearly the up-to-date market dynamics. Experienced advisors can assist an investor considering an investment in China by providing them with a full understanding of the potential regulatory issues, market segment risks, or the company in which they are investing. Ultimately, not all investors will find the market environment in China to their liking, but for those who see an opportunity, an informed decision should only be made on the basis of reliable, unbiased, and timely information.

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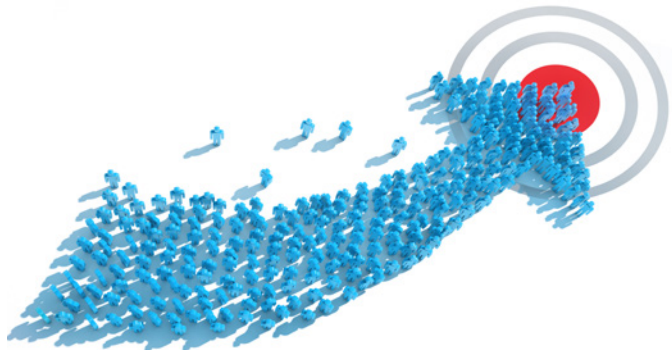
HOW SPECIAL PURPOSE ACQUISITION COMPANIES WORK… AND THE CHALLENGES AHEAD



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Special purpose acquisition companies (SPACs) have become a preferred way for many experienced management teams and sponsors to take entities public. A SPAC raises capital through an initial public offering (IPO) for the purpose of acquiring an existing operating company. Subsequently, an operating entity can merge with (or be acquired by) the publicly traded SPAC to become a listed entity in lieu of executing its own IPO.

This approach offers several distinct advantages over a traditional IPO, such as providing entities access to capital even when market volatility and other conditions limit liquidity. SPACs may also result in lower transaction fees as well as expedite the timeline to become a public company.

Generally, a SPAC is formed by an experienced management team or a sponsor with nominal invested capital, typically translating into a ~20% interest in the SPAC, commonly known as founder shares. The remaining ~80% interest is held by public shareholders through "units" offered in the SPAC's IPO. Each unit consists of a share of the SPAC's common stock and a fraction of a common stock warrant; e.g.,1/2 or 1/3 of a warrant.

Founder shares and public shares generally have similar voting rights, with the exception that founder shares usually have sole right to elect SPAC directors. Generally, warrant holders do not have voting rights and only whole warrants are exercisable.

A SPAC's IPO is typically based on an investment thesis focused on a sector and geography, such as the intent to acquire a technology company in North America, or a sponsor's experience and background. Following the IPO, proceeds are placed into a trust account and the SPAC typically has 18-24 months to identify and complete a merger with a target entity, sometimes referred to as de-SPACing. If the SPAC does not complete a merger within that time frame, the SPAC will liquidate and the IPO proceeds are returned to the public shareholders.

Once a target entity is identified and a merger is announced, the SPAC's public shareholders may vote for the transaction while at the same time electing to redeem their shares. If the SPAC requires additional funds to complete a merger, the SPAC may issue debt or issue additional shares, such as a private investment in public equity (PIPE) deal.

Once the SPAC is formed, the SPAC will typically need to solicit shareholder approval for a merger. Subsequent to approval of the SPAC merger and clearance of all regulatory matters, the merger will close and the target entity becomes a public registrant.

Recent SPAC Trends

US SPAC IPOs reached their previous high in 2007, raising $12 billion. In 2020, there was an estimated $75 billion raised by SPACs looking for targets. In Q1 2021, an estimated $87 billion was raised. This was followed by a dramatic decrease in the second and third quarter of 2021, with proceeds raised of $12 billion and $16 billion, respectively (see Exhibits 1 and 2).

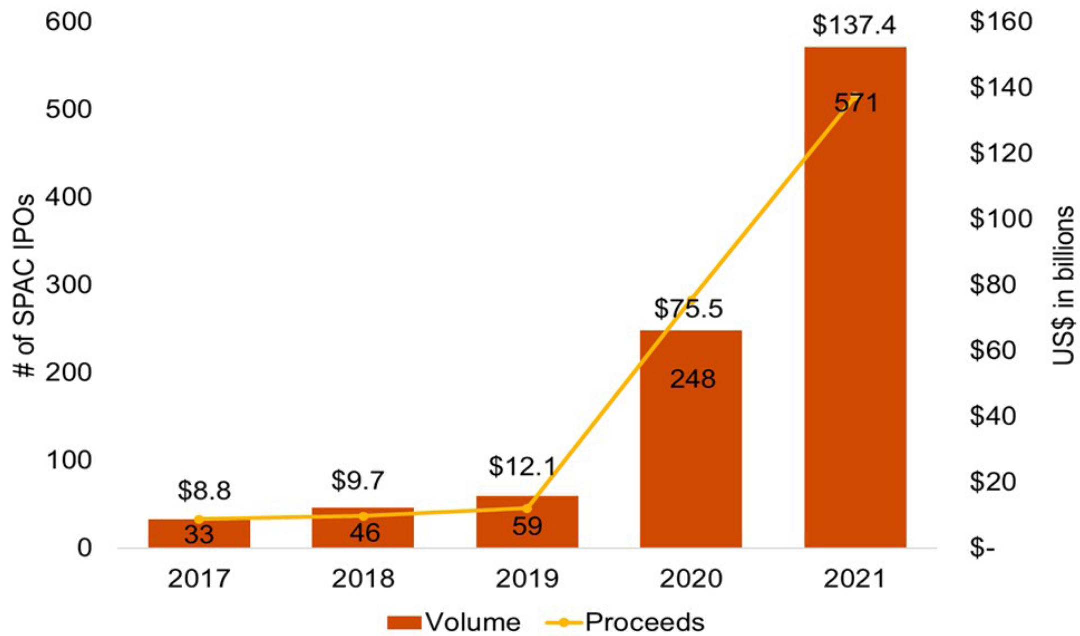
SEC Turns Attention to SPAC Surge

Coinciding with the decrease of SPAC volume in Q2 2021, the SEC issued guidance in April questioning whether warrants issued by hundreds of SPACs should be considered liability or equity classified instruments. Historically, SPACs had frequently classified such instruments as equity. The change in classification of the warrants caused many SPACs to restate their historical financial statements and generally slowed the pace of deal timelines.

Challenges for Target Companies After Going Public

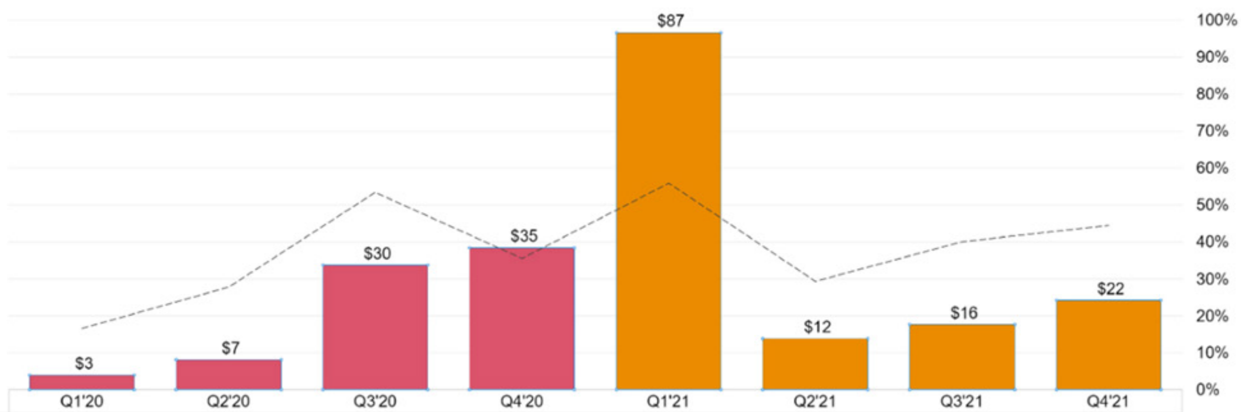
Entities that have gone through a SPAC merger may have accelerated their plans to prepare for being a public registrant. One factor that a newly public registrant must deal with is the ongoing cost of maintaining status as a public entity. Another factor is the increase in regulatory and reporting requirements

Exhibit 1: US SPAC IPOs Annual Volume, 2017 - 2021



Source: Dealogic data as of 12/2/21

Exhibit 2: US SPAC IPOs Quarterly Data, 2020 - 2021



	Q1'20	Q2'20	Q3'20	Q4'20	Q1'21	Q2'21	Q3'21	Q4'21
Total SPAC Funding	$3	$7	$30	$35	$87	$12	$16	$22
# of SPACS	13	24	82	129	301	64	87	120
Average SPAC ($mm)	$268	$302	$369	$268	$289	$194	$183	$182
Largest SPAC ($mm)	$1,000	$900	$4,000	$1,000	$1,500	$530	$450	$360
% of Total IPO Market	16%	28%	53%	36%	56%	29%	40%	44%

--% of Total IPO Market

Source: Dealogic data as of 12/2/21

and the fact that the infrastructure of the entity may not have been designed to meet the demands of reporting requirements for public entities.

Sponsor Incentivization and Timeliness for Transaction Execution

Sponsors are highly incentivized to identify a target entity and complete the merger process. Additionally, under the SPAC structure, the sponsors generally have 24 months to complete a target search, reach an agreement, and acquire an entity; otherwise, the SPAC is dissolved and the funds are returned to the public shareholders. The deadline created by the SPAC's expiration date can result in a compressed timeline to complete due diligence processes to sufficiently vet viable target entity candidates. If a situation arises where there is a surplus of SPACs compared to entities that are targets to go public, the quality of target entities could diminish.

Redemption Features

The SPAC merger is required to be brought to a shareholder vote. Shareholders who hold the SPAC's public shares also have the right to redeem the public shares while keeping their warrants and separately voting yes for the proposed SPAC merger. In recent experiences during Q3 2021, the level of redemptions by SPACs' public shareholders has been higher than in

Continued from p.21

deals that closed earlier in 2021, resulting in the target entity heavily relying on backstop financings such as PIPE investments or even debt issuances to ensure sufficient funding for a public company. The potential strain on capital structures caused by the higher level of redemptions may disrupt strategic plans and put unplanned liquidity stress on the target entities that de-spac.

Target Entity Financial Projections

Target entity financial projections, or forward-looking statements, have continued to be a topic of ongoing discussion. These projections are often included in the materials prepared for the SPAC's public investors voting on the merger, with the intent of capturing the forecasted performance of the entity after the merger has occurred. Not achieving or performing against these projections may create a negative sentiment for investors and increase shareholder pressure.

Ongoing Impact of COVID-19

The continuing impact of COVID-19, as well as other unforeseen macroeconomic conditions, may introduce additional risk to the success of a SPAC merger transaction. Tightening labor markets and supply chain issues are examples of factors entities are currently experiencing. Labor constraints have posed a particularly pronounced impact to the service industry, specifically where revenue generating activities are labor intensive. Supply chain issues have had a significant impact in 2021 for businesses across many industries and geographies. A new public registrant, including those without historical positive cash flows, may not be ideally positioned to react to these types of economic disruptions. Adjusting business strategies in response to such issues may present a challenge for these new public registrants under the scrutiny of the public markets. While qualified targets and many businesses have recovered from liquidity pressures, largely attributable to access to capital, uncertainty does exist prospectively.

Distressed Targets for SPACs

Some SPAC managers have taken interest in the distressed market for potential target entities. The market cap of an entity in bankruptcy or one that has recently emerged from a reorganization may still be negatively impacted due to the restructuring and associated connotations, providing potential inherent value to the SPAC. Additionally, going through the bankruptcy process often means that an entity has cleaned up its balance sheet and/or renegotiated contracts to benefit the go-forward entity.

The Road Ahead . . .

New public registrants formed as a result of a SPAC have access to capital; however, as undue costs and a changing business environment continue to evolve, longer term trends may lead to future restructuring candidates.

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WHEN AND WHY SHOULD YOU HIRE AN INTERIM MANAGER?

JEFF HYLAND and BARAK TULIN
CR3 Partners

How do a management team and Board of Directors know when to engage an interim manager, and how do different situations determine the type of interim manager they should hire? This article discusses five situations in which engaging an interim manager is crucial to achieving a positive outcome and how each situation calls for different skills and attributes.

"How did you go bankrupt?" Bill asked.

"Two ways," Mike said. "Gradually, then suddenly."

– Ernest Hemingway, *The Sun Also Rises*

Experienced business leaders know there are occasions when engaging an interim manager is critical to helping the organization succeed. And although more interim managers are hired outside a bankruptcy than within one, it is often difficult to determine when a company is gradually moving to the point of needing an interim manager – until it suddenly needs one.

The situations in which an organization's Board of Directors and its executive team should engage an interim manager typically have three attributes in common. First, these situations are almost always unplanned. Second, they often create an inflection point that can lead to the success or failure of a business segment, a corporate function, or even the entire organization. Third, they require an urgent response from the company's leaders before the situation defines the organization's path and it becomes too difficult to reverse.

In our colleagues' collective experience of managing both healthy and distressed organizations, we have identified five specific situations in which engaging an interim manager is crucial to achieving a positive outcome:

1. C-suite vacancy with an incomplete succession plan
2. Crisis management requiring a unique skill set
3. Rebuilding stakeholder trust
4. Stabilizing the company during and after an M&A process
5. Managing special projects

The differences among these situations relate to the skill sets required to manage them, the degree of distress in each, and the expected time frame to complete the interim management role, all of which are shown on a relative basis in Exhibit 1.

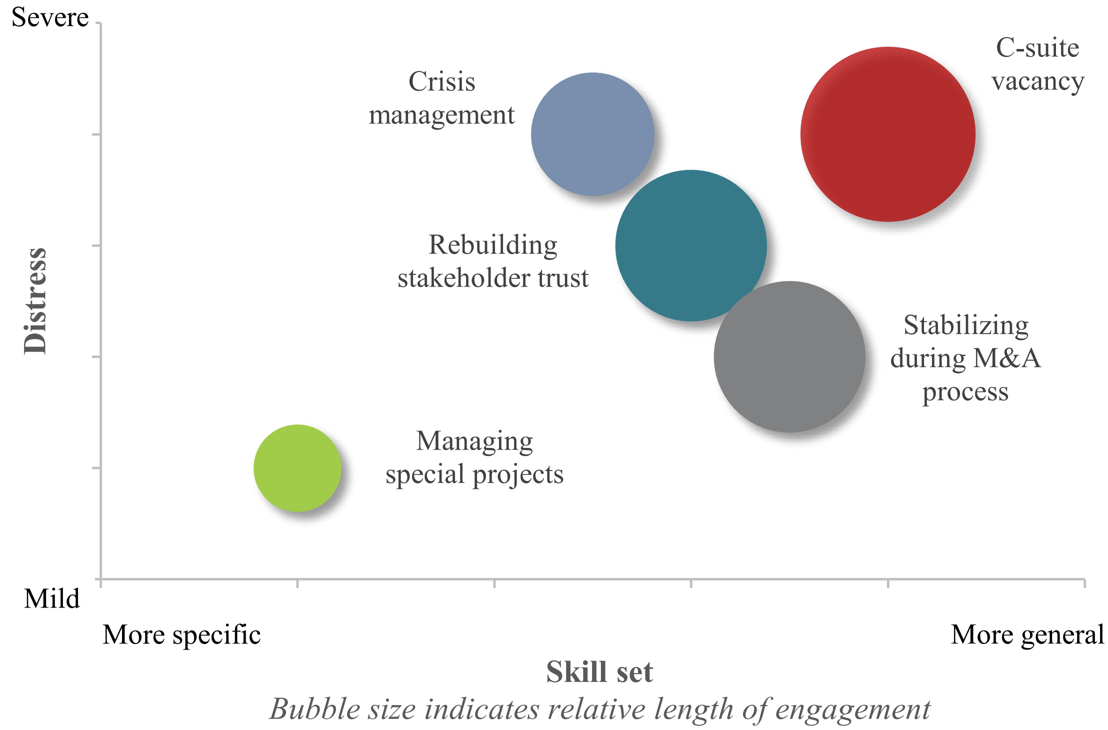
1. C-Suite Vacancy with an Incomplete Succession Plan

Although vacancies in an executive team occur regularly, those with an incomplete succession plan to address them are the most problematic. On those occasions, a company can find itself in a growing leadership crisis due to an executive's resignation, termination, illness, or death. Because the company has not planned sufficiently for the executive's departure, it may find itself without the bench strength or an outside hire to fill even short-term gaps in functional leadership. The eventual distress that often surrounds these situations makes a C-suite vacancy, whose candidates take disproportionately longer to recruit than other positions, even more challenging to fill. Finally, the distress caused by the leadership vacuum eventually deteriorates the performance of other key employees and their departments.

A strong interim management candidate with a broad skill set of running virtually all groups in the C-suite can fill the short-term void and help ensure a smooth transition for customers, suppliers, personnel, and other stakeholders. Such an appointment typically lasts longer than other interim management engagements because of the time needed to reset the organization's tone, realign expectations, and create a foundation for sustainable long-term performance with an eventual permanent CEO.

In one consumer products manufacturing client, the founder who was loved and admired in both his company and industry became stricken with cancer and quickly passed away. The founder had such a strong personal style and a high degree of influence that no one considered developing a succession plan in the event of a leadership vacuum. Despite this sudden shock to the previously successful organization, the company's Board acted within days to engage an interim CEO, granting him a broad mandate to stabilize the business and eventually position it for its sale. The interim CEO provided stability to the customers, suppliers, and employees, all of whom were concerned about the founder's sudden demise. The interim CEO quickly stabilized and grew the business through reducing costs, refining market strategy, and driving revenue growth. Based on the highly successful short-term transition of the company, it was recommended to the Board that the business be sold. The Board agreed, and the net outcome was a lucrative return

Exhibit 1: Interim Management Situations



for the shareholders, a positive result for the other stakeholders, and a sustainable future for the company in the hands of another owner.

2. Crisis Management Requiring a Unique Skill Set

Companies can benefit from interim managers in both financially strong and failing situations. However, interim managers require a unique set of restructuring skills when the business gradually declines and suddenly finds itself in a financial crisis. These interim managers often carry the title of Chief Restructuring Officer (CRO), require a different mindset and agreed-upon objectives irrespective of the C-suite title, and have a more defined time frame to fulfill those objectives than an interim CEO.

The core of the CRO's mandate is to improve performance, increase profitability, and achieve specific goals as part of the restructuring process, whether in court or out of court. These goals range from stabilizing and turning around a company to managing a bankruptcy process that enables reorganization or the sale of a company as a going concern. The CRO's goals, and the hundreds of critical and rapid decisions that support them, are often challenging for even the most experienced managers. Whether serving as CRO of the largest poultry producer in the U.S., a Major League Baseball team, an offshore energy producer, a chain of casual-dining restaurants, or a steel processor, highly effective CROs act to stabilize a troubled business, establish clear and frequent communication with employees and stakeholders, manage the in-court or out-of-court process, and return significant value to the financial constituents – in some cases, significantly in excess of their expected recoveries.

3. Rebuilding Stakeholder Trust

Think of a company as a living and breathing entity that requires the support of many other companies and individuals, who in turn rely on its long-term viability. Occasionally, those stakeholders lose faith in the C-suite's ability to execute a plan that maximizes the company's prospects and long-term value. An interim manager is ideally suited to provide an independent, third-party assessment and implement the realignment of the company's strategies, tactics, and communications over time. This often takes place in a moderately distressed situation and requires an interim manager with a skill set focused on managing stakeholders along with the operating experience needed to manage the company through a deficit of stakeholder trust.

For example, one of our privately-owned manufacturing clients had lost the faith of its lender. The company had initiated a roll-up strategy with several acquisitions, but its senior leaders were mired in continual disputes among themselves and faced allegations of ethical and accounting-related improprieties. As a condition of providing additional funding to the company, the lender insisted that it engage an interim manager to assess the situation, tighten controls, improve critical decision

Continued from p.25

making, and ultimately reestablish internal and external credibility. The interim manager immediately corrected the accounting errors and initiated a consistent and ongoing communications protocol with the stakeholders to reestablish credibility and confidence in the company's future direction. Once the company demonstrated it was following sound business principles and had reestablished open and honest communication, the trust of the stakeholders was regained. This provided the runway and support needed to divest from non-strategic operations, improve profitability, and ultimately sell the business, which maximized stakeholder value and proved to the lenders that their trust was well placed.

4. Stabilizing the Company During and After an M&A Process

Whether or not they succeed in the long term, mergers and acquisitions place significant stress on existing management and stakeholders of the pre- and post-transaction entities during the M&A process. First, the pre-transaction company must remain stable during that period in order not to risk changing the economic terms of the transaction or the likelihood of consummating it. Second, the period immediately following the transaction requires an unrelenting focus on stabilization and integration. Third, members of the current C-suite may take a dim view of their career opportunities post-transaction and choose not to follow the sold company or even leave before the company is sold, embedding a leadership void in the organization before the deal is signed.

An interim manager with a broad operational skill set, along with specific experience in managing post-merger integrations and setting up his or her position to be filled by a permanent hire, is the best fit for this situation if the buyer concludes that the post-transaction entity may need to be managed by an executive team with different attributes than the pre-transaction entity.

It is difficult to overstate the importance of keeping the right team together post-close while managing the multiple work streams of integrating a newly merged company. Projecting leadership and demonstrating capabilities during this time is crucial to the success of the business post-merger. Once the interim manager has ensured the C-suite functions (e.g., operations, finance, sales, etc.) have a proper foundation post-close, a permanent C-suite candidate can be hired to take the company forward. This can often take more time than the company's new owners care to admit, but much like with an unplanned C-suite vacancy, the investment in creating a company that can be advanced by a permanent C-suite executive usually pays for itself quickly.

In the reverse situation where a business is being carved out of a larger entity, the interim manager of the post-transaction company should have attributes and experience more like those of a hands-on General Manager than a CEO. The interim manager can then evaluate management's ability to step into a more prominent role or lead the organization during a transition while the permanent executives are recruited. In these instances, a CEO's attributes may be mismatched with what the company actually needs; we have witnessed several companies hire someone too strategically focused to run a division and unable to perform the basic blocking and tackling required to manage a smaller and more focused business. For the smaller carve-out situations in which we have been engaged, a detail-oriented General Manager with a balance of strategic and tactical thinking has typically been the stronger candidate.

5. Managing Special Projects

As objectives and goals within a company evolve, the demands on its C-suite executives also change. Major initiatives and projects can require skill sets that extend beyond normal operating expectations.

For example, a Board may acknowledge the requirement for specific skills to launch a product line, negotiate with influential customers during a significant new initiative, or implement operational changes at plants, divisions, and corporate functions. Additionally, multinational enterprises often require new, local talent as they geographically expand across borders and encounter new cultures, languages, employment laws, and business practices.

Due to the limited mandate and time frame of these assignments, along with the relatively lower level of distress that accompanies them, an interim manager with highly specific skills and a defined scope against which to execute the project would be an ideal choice. An interim manager can provide the local guidance and jump-start the new initiatives while a permanent solution is found, and the existing management team can focus on managing the company while these special projects are brought to a successful close.

The Choice: Empower the Interim Manager or Deal with the Problem Yourself.

No matter what the nature of interim management engagements, we have observed a common theme throughout each of them: the company must fully and clearly empower the interim manager to perform their role. Though this is a seemingly obvious statement, we have worked in the past with management teams and Boards of Directors that do not provide the interim manager sufficient resources or political support to do their job.

The key to properly empowering the interim manager is to:

1. Establish as specific and time-bound a scope of work as possible;
2. Demonstrate public support from both the rest of the management team and the Board of Directors;
3. Enable the interim manager to be integrated immediately with the existing team; and
4. Insist on two-way communication between the interim manager and employees.

This last point is often neglected, but it is the most critical one in some instances and ultimately necessary for the interim manager's success. Most employees view interim managers as either a temporary nuisance ("they won't be my problem for much longer") or a harbinger of their own termination ("I won't be their problem for much longer"). Communication is critical to the typical work of turning around companies: it keeps crucial employees engaged, eliminates the information vacuum that drives fear among the troops, and maintains an open line of discussion among all parties that, if dealt with constructively, can help the business succeed during the interim manager's tenure at the company.

Whatever interim management path a company's Board of Directors and management team choose to take, empowering the interim manager is critical to the business's near-term success and eventually filling their position with a permanent hire. Otherwise, management teams without the necessary skills or bandwidth may have to deal with these issues on their own – and like Hemingway's character, find that after gradually sliding toward a crisis, they are suddenly in the midst of one.

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Jeff is a Partner in CR3 Partners' Chicago office. Over the last 30 years, he has served in permanent and interim CEO roles and provided management consulting services to both large and middle-market companies that required strategy definition, restructuring, investment-banking services, and operational enhancements. Before joining CR3, Jeff served as President and CEO of a publicly traded international manufacturer of consumer goods and commercial films; provided turnaround and restructuring services to a major telecommunications provider; and worked in the finance organization of a teaching hospital. Jeff received his MBA at Northwestern University in Marketing, Finance, and Hospital and Health Services Management, and is a CPA and CTP.

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RELATIVE VALUATION AND THE RELEVANCE OF GUIDELINE COMPANY MULTIPLES

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Province, LLC

Introduction

Market multiples based on the prices of guideline publicly traded companies or the prices at which similar companies were sold are at times used alone, as a sanity check on values calculated using other methods, or to assess how the market has changed over some period. The method appears simple and direct: (i) identify guideline companies, (ii) scale the firm or equity value of each guideline company standardizing by a relevant driver of value (i.e., Revenue, EBITDA, EBIT, Free Cash Flow, Earnings, Book Value of Equity), (iii) determine the range of multiples to apply to the subject firm, and (iv) multiply the selected multiple(s) of the guideline companies by the corresponding value driver of the subject company. The selection and calculation of guideline company multiples is a complex undertaking, however, involving much more than simple division, particularly in cases where the facts and circumstances may warrant adjustments to the guideline company multiples for size and or growth, such as where the subject company is privately held and small, while the revenues, assets or market capitalizations of the guideline publicly traded companies are in the millions or billions of dollars. Establishing the relevance of guideline company multiples consequently requires analysis of the correlation of the determinants of the multiples being used and evaluation of whether adjustments are necessary for differences including excess or non-operating assets; onetime, non-recurring events; the effects of transactions, differences in accounting principles, firm size and growth.

Relationship Among Market Multiples, Risk and Growth

The value of a firm is equal to the risk-adjusted present value of its expected free cash flows. Viewed from the perspective of the Gordon Growth formula below stated as a constant growth perpetuity applied to free cash flow ("FCF"), the value of the firm is equal to the present value of its FCF, where r is the cost of capital and $g_{t=1,\infty}$ is the weighted average growth rate for the firm's FCFs from year 1 in perpetuity.

$$V_{\text{Firm, t=0}} = FCF_{t=1} / (r - g_{t=1,\infty})$$

Restating this equation to calculate the FCF market multiple ("MM") demonstrates that the FCF multiple is equivalent to the capitalization factor $(1 / (r - g_{t=1,\infty}))$ in the Gordon Growth model.

$$MM_{FCF} = V_{\text{Firm, t=0}} / FCF_{t=1} = 1 / (r - g_{t=1,\infty})$$

Framed this way, the FCF multiple indicates the price an investor would pay for a dollar of free cash flow based on its risk and expected rate of growth. Coming full circle, as the value of a firm is equal to the risk adjusted present value of its free cash flows, the determinants of which are risk and growth, regardless of what multiple is used, the comparability of comparable companies should be evaluated in terms of risk and growth in free cash flow.[1]

Additional Determinants

Factors that influence the comparability of firm-value market multiples are not limited to risk and growth. Depending on the subject multiple, the relevant characteristics may include required investments in net operating working capital and capital expenditures and the structure of income tax costs, depreciation costs, and operating costs, including cost of goods sold, R&D and SG&A.[2]

Market Multiple of Unlevered Earnings

In addition to risk and growth, the market multiple of Unlevered Earnings ("UE")[3] is a function of the firm's investments in net operating working capital ("NOWC") and capital expenditures ("CAPEX"). Equal to the change in NOWC (net operating working capital percentage multiplied by the growth rate in revenues) plus CAPEX (capital expenditures percentage multiplied by the growth rate in revenues) divided by UE,[4] the Plowback ratio ("PB_{UE}") represents the proportion of UE that must be invested to support growth. Restating the FCF multiple formula below for UE shows that like the FCF multiple, the UE multiple decreases with increases in risk and increases with increases in the growth rate. The larger the Plowback ratio, however, the lower the UE multiple. Though operating expenses, depreciation expense and the tax rate also affect the UE multiple, the effects are small as the value of the firm and UE are similarly affected.

$$MM_{UE} = V_{\text{Firm, t=0}} / UE_{t=1} = (1 - PB_{UE}) / (r_{WACC} - g)$$

[1] Robert W. Holthausen and Mark E. Zmijewski, *Corporate Valuation: Theory, Evidence & Practice,* 2nd Ed. (Westmont: Cambridge Business Publishers, LLC, 2020), 618.

[2] *Ibid.*, 627-32.

[3] $UE = EBIT \times (1 - Tax\%)$

[4] $PB_{UE} = \{(NOWC\% + CAPEX\%) \times g \times R_{t=0}\} / UE_{t=1}$

Market Multiple of Earnings Before Interest and Taxes

In addition to risk, growth and the plowback ratio, the EBIT multiple is determined in part by the income tax cost structure ("Tax%"). Unlike the UE multiple, however, the Plowback ratio is measured relative to EBIT ("PB_{EBIT}"). While EBIT is not affected by the firm's tax rate, the higher the firm's income tax cost structure, the lower its EBIT multiple. Operating and depreciation expenses also affect the EBIT multiple. The effects are slight, however, as the value of the firm and EBIT are similarly affected.

$$MM_{EBIT} = V_{Firm,\,t=0} / EBIT_{t=1} = (1 - Tax\% - PB_{EBIT}) / (r_{WACC} - g)$$

Market Multiple of Earnings Before Interest, Taxes and Depreciation

The determinants of the EBITDA multiple include the firm's depreciation cost structure ("DEPR%")as well as the risk, growth, plowback ratio and income tax cost structure factors underlying the EBIT multiple. As with the EBIT multiple, the determinants of the EBITDA multiple include the Plowback ratio, albeit measured in relation to EBITDA ("PB_{EBITDA}"). Though EBITDA is not affected, the higher the depreciation cost structure, the lower the multiple of EBITDA and value of the firm. Operating expenses ("OE%") also affect the EBITDA multiple. The effect is marginal, though, since the effect on the value of the firm and EBITDA is comparable.

$$MM_{EBITDA} = V_{Firm,\,t=0} / EBITDA_{t=1} = \{1 - Tax\% - [DEPR\% \times (1 - TAX\%)/(1 - OE\%)] - PB_{EBITDA}\} / (r_{WACC} - g)$$

Market Multiple of Revenue

The Revenue multiple is like the EBITDA multiple determined by risk, growth, the plowback ratio (measured relative to revenue "$PB_{Revenue}$"), income tax and depreciation cost structures. The determinants of the Revenue multiple, however, also encompass the firm's entire operating cost structure. Included are costs such as SG&A, R&D and COGS. Consequently, it can be difficult to identify comparable companies for use with the Revenue multiple, which causes it to be less useful in a valuation based on market multiples. Though not affecting revenue, a higher cost structure will result in a lower value.

$$MM_{Revenue} = V_{Firm,\,t=0} / R_{t=1} = \{1 - Tax\% - [(OE\% + DEPR\%) \times (1 - TAX\%)] - PB_{Revenue}\} / (r_{WACC} - g)$$

Market Multiple of Total Invested Capital

The determinants underlying the Total Invested Capital ("TIC") multiple are the same as that of the Revenue multiple. The TIC multiple is, however, more sensitive to the investments required to support growth. As shown below, the TIC multiple is equal to the multiple of UE multiplied by the return on the beginning balance of the firm's TIC. As the UE multiple decreases with increases in the Plowback ratio, while at the same time TIC increases, the combined effect is to reduce the return on TIC and value of the firm.

$$MM_{TIC} = V_{Firm,\,t=0} / TIC_{t=0} = (V_{Firm,\,t=0} / UE_{t=1}) \times (UE_{t=1} / TIC_{t=0})$$

Relevance of Firm Size

In valuation practice it is common to select comparable companies based in part on size (i.e., revenue, assets, market capitalization). Currently, however, there is no theoretical model that identifies size as a determinant of market multiples.[5] Empirical research is also varied with respect to the relevance of size after accounting for industry and other determinants. However, market evidence does indicate that size is related to stock returns after accounting for expected returns indicated by the Capital Asset Pricing Model.[6] On balance, then, due to the potential ambiguity regarding which of the set of market multiple determinants are most relevant given the facts and circumstances of the particular valuation and the challenge of forecasting those determinants for the comparable companies, firm size is likely to be useful absent estimates of other determinants.

Adjustments for Growth, and Size Differences

Growth

The purpose of adjusting the growth rates implicit to the multiples of guideline companies is to recast their pricing multiples such that they reflect the expected growth of the firm being valued rather than that of the guideline companies, while retaining other characteristics.[7] However, the growth that is reflected in the guideline company multiples is that of long-term, or perpetual growth, which is problematic in that the growth rates for publicly traded firms are by and large available only for the next three to five years. Consequently, it is necessary to calculate a constant, or blended growth rate in perpetuity. Using Year 0 as the base year, the present value weighted average growth rate can be calculated using the formula

$$g = r - FCF_1 / V_{F,0}$$

where g equals the present value weighted average growth rate, r equals the discount rate, FCF_1 equals free cash flow in year 1 and V_0 equals the value of the firm at time equals 0.[8] Stated differently, solving for g_0, the present value weighted average growth rate must satisfy the equation shown in exhibit 1 on the next page:[9]

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5 Holthausen and Zmijewski, 634.

6 *Ibid.*, 658, 663-4.

7 James R. Hitchner, *Financial Valuation: Applications and Models*, 3rd Ed. (Hoboken: John Wiley & Sons, Inc., 2011), 301-04.

8 Holthausen and Zmijewski, 260.

9 Hitchner, 302-3.

Continued from p.29

Exhibit 1

$$\text{Value} = \frac{CF_1}{r - g_0} = \frac{CF_1}{(1+r)^1} + \frac{CF_1(1+g_1)}{(1+r)^2} + \frac{CF_1(1+g_1)^2}{(1+r)^3} + \frac{CF_1(1+g_1)^3}{(1+r)^4} + \frac{CF_1(1+g_1)^4}{(1+r)^5} + \frac{\dfrac{CF_1(1+g_1)^4(1+g_2)}{(r-g_2)}}{(1+r)^5}$$

Where:

g_1 = the growth rate assumed for the five-year discrete projection period, in the example, five years,

g_2 = the growth rate during the terminal period,

r = the discount rate, and

CF_1 = Cash flow in year 1.

The formula for adjusting the guideline companies' multiples for differences in growth is then

$$\text{Multiple}_{\text{Adjusted}} = 1 / [(1 / \text{Multiple}_{\text{Original}}) + g_{\text{Original}} - g_{\text{Adjusted}}]$$

where g_{Original} is the guideline company's expected present value weighted average growth rate and g_{Adjusted} is the subject company's expected present value weighted average growth rate.

Size

As discussed above, empirical market evidence indicates that size is related to excess stock returns after accounting for expected returns indicated by the Capital Asset Pricing Model. Consequently, valuation analysts may limit the selection of guideline companies to firms close in size to that being valued. Often, however, otherwise relevant guideline companies differ significantly with respect to size. Adjusting the guideline company multiples for size mitigates this difference while retaining information consistent with that from firms similar in size to the subject firm.[10]

The generalized formula for adjusting the guideline companies' multiples for differences in size is[11]

$$\text{Multiple}_{\text{Adjusted}} = 1 / (1 / \text{Multiple}_{\text{Original}}) + (\infty\, \varepsilon\, \theta)$$

were θ is the increase in the equity discount rate associated with the size premium differential, ∞ is a scaling factor applied to θ when adjusting a multiple other than net income or after-tax operating profit (i.e., ratio of revenues to after-tax operating profit), while ε is an adjustment (the ratio of equity to invested capital) made to θ when there is debt in the capital structure and a pricing multiple based on the market value of invested capital is being used.[12]

Adjustments for Non-operating Assets, Non-Recurring Items, Transaction Effects and Changes in Accounting Principle

The comparability of market multiples is also a function of the consistency between the financial data inputs of the comparable and subject companies. Consequently, adjustments may be necessary to ensure consistency between claims on the value of the firm included in the numerator and denominator of the multiple, and that the measures included in the numerator and denominator both reflect long-run operating performance. In general, the adjustments can be classified as related to excess or non-operating assets, one-time, non-recurring events, the effects of transactions and changes in accounting principle.[13]

Excess Assets

Excess, or non-operating, assets include any asset that is not required for the company's ongoing core operations. Examples include net operating losses, excess cash and marketable securities among other items.[14] The income statement is adjusted by eliminating the income effects attributable to the excess asset, while the balance sheet is adjusted by eliminating the amount reported for the excess asset. The value of the excess asset is also subtracted in calculating enterprise value.

One-Time, Non-Recurring Events

Non-recurring items include restructuring charges, asset impairment charges, one-time gains or losses from the divestiture of assets or redemption of liabilities and other items that may distort a firm's cash flow from core operations.[15] The income statement is adjusted by eliminating the income effects attributable to the non-recurring event, while the effects of recording the non-recurring item on the balance sheet are reversed. There is usually no need to adjust the enterprise or equity value as the non-recurring event is typically already reflected having been previously disclosed.

Mergers, Acquisitions and Divestitures

Mergers and acquisition may break the relationship between historical and future cash flows.[16] When a firm is acquired, the buyer records the income and cash flow from the target as of the closing date of the acquisition. Consequently, the income and cash flow statements of the buyer may only account for a partial year of income and cash flow from the target. The buyer's financial statements will consequently not reflect long-term performance. It is then necessary to adjust the combined firm's income and cash flow statements to include the income and cash flow of the target realized in the current fiscal year prior to the

10 Hitchner, 304-6.

11 See also Mattson, Shannon and Drysdale, "Adjusting Guideline Multiples for Size", *Valuation Strategies*, September/October 2001.

12 Gary R. Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses, 5th Ed.* (New York: American Institute of Certified Public Accountants, 2017), 373-5.

13 Hitchner, 658; 663-4.

14 Contested Valuation in Corporate Bankruptcy: A Collier Monograph, ¶ [9.03] (Robert J. Stark et al. eds., 2011).

15 *Ibid.*

16 *Ibid.*

closing date. The enterprise and equity values are usually not adjusted as having been previously disclosed, the transaction is already reflected.

Conversely, given that as of the divestiture closing date, the enterprise value and balance sheet do not include the value of the operations that were sold, the seller's income and cash flow statements are adjusted to eliminate the income and cash flow of the divested operations that was recorded in the current fiscal period prior to the closing date. Enterprise value is not adjusted except where cash is realized in the transaction.

Discontinued Operations

A discontinued operation is an operating segment that a firm intends to divest or has divested and that meets the criteria to be considered a discontinued operation.[17] The disposal of a large geographic area, major line of business and significant equity method investment are examples. The income statement and cash flows are adjusted to eliminate the income effects attributable to the discontinued operations, while the balance sheet is adjusted to eliminate the reported balance. The value of the discontinued operations is also subtracted from enterprise and equity value.

Unconsolidated Affiliates

An unconsolidated affiliate is an entity in which a firm has an equity interest, the financial results of which are not consolidated with its own.[18] Rather, the firm's investment is reported as a one-line entry in its income statement and balance sheet. If data permits, the income statement and cash flows are adjusted to eliminate the income effects attributable to the unconsolidated affiliate, while the balance sheet is adjusted to eliminate the reported balance. The value of the unconsolidated affiliate is also subtracted from enterprise and equity value.

Minority Interests

With a minority interest, the parent records all of the subsidiary's revenues, expenses, assets and liabilities on the consolidated company's income statement, balance sheet and cash flow statement.[19] At the same time, however, the parent subtracts (adds) the income (loss) attributable to the portion not owned by the parent on the consolidated income statement, while minority interests are reported as part of total equity on the consolidated balance sheet. Accordingly, the consolidated income statement is adjusted to include all of the subsidiary's income, while the consolidated balance sheet is adjusted to include the noncontrolling interests in shareholders equity. The value of the minority interest is added to enterprise and equity value.

Leases

Under the new accounting rules, firms are required to capitalize all leases with a contractual term greater than twelve months. Further, leases continue to be classified as either financing or operating, with the lease expense for operating leases treated solely as an operating expense. To convert operating leases to financing leases under the new accounting rules, the income statement is adjusted to eliminate operating lease expense and to add the amortization of the leased asset and record interest on the lease liability. Given the current rules, the balance sheet is adjusted by adding the value of the leased asset and related liability. The value of the capitalized lease is added to enterprise value.

Summary and Conclusion

Market multiples based on guideline publicly traded companies are often used to calculate the value of a firm, its equity or a transaction. The set of relevant multiples may include that of Free Cash Flow, Unlevered Earnings, EBIT, EBITDA, Revenue and TIC. Regardless of the multiple, the guideline and subject companies must be assessed in terms of risk and growth. Moreover, it may also be necessary to compare the firm's required investments and structure of income taxes, depreciation and operating costs. While there is currently no theory that identifies size as a determinant of market multiples, firm size may be useful absent estimates of other determinants. Where otherwise relevant guideline companies differ significantly with respect to growth and or size, the guideline company multiples may be adjusted such that they reflect the expected growth and size of the firm being valued rather than that of the guideline companies, while retaining other relevant characteristics. Similarly, inconsistencies between the guideline and subject company financial data require that the inputs to the multiples be adjusted for differences in non-operating assets, non-recurring items, transaction effects and changes in accounting principle. Together with analyses of the underlying determinants, doing so is essential to establishing the relevance of guideline company multiples in a relative valuation.

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Boris J. Steffen, CDBV, is a Managing Director with Province, Inc. With over 30 years experience as a financial advisor and expert witness to holders of interests and claims on matters of accounting, finance, valuation and solvency, he has consulted in over $100 billion of mergers, acquisitions and restructurings. As such, his practice has included Special Litigation Committee service, acting as the independent accounting expert in post-closing working capital disputes, evaluating asset acquisitions and serving as an expert witness with respect to issues including the interpretation of accounting principles, allocation of costs, specificity of merger synergies, actual and constructive fraudulent transfers, and fair value, including before the Delaware Court of Chancery.

[17] Holthausen and Zmijewski, 663.
[18] *Ibid.*, p. 663-4.
[19] *Ibid.*, p. 664.

TREATMENT OF PPP LOAN FORGIVENESS

RYAN CORCORAN and JOHN CHARIN
RSM US LLP

In November 2021, the Internal Revenue Service (IRS) released a series of revenue procedures to provide guidance on how to take into account loan forgiveness under the Paycheck Protection Program (PPP) loan program for federal income tax purposes. This guidance was greatly anticipated, as it addresses many of the practical questions about the timing for recognizing tax-exempt income, how particular entities should treat exclusions from income and deductions, and how BBA partnerships can take the guidance into account.

Background

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act)[1] established the PPP to disburse federal funds to help get businesses through the pandemic and retain employees. The PPP uses the Small Businesses Administration (SBA) "7(a) Loan Program"[2] as a structure for enabling businesses to obtain funds. Though structured as loans, these loans were not meant to be repaid if taxpayers qualified for the loans and used them properly over a set covered period. The CARES Act allowed the SBA to guarantee covered PPP loans[3] and instructed taxpayers to exclude forgiven PPP amounts from gross income.[4]

Section 61(a)(11) ordinarily requires most taxpayers to include discharged debt in gross income. While PPP funds create income, the law instructs taxpayers to exclude that income from taxable income. To better effectuate the PPP's purpose, the Consolidated Appropriations Act of 2021 followed up to fill in gaps and ensured that taxpayers may deduct expenses related to loans forgiven or expected to be forgiven.[5]

With a patchwork of law and guidance covering two draws of PPP loans, and particularly with a novel form of debt and excludable debt forgiveness income, taxpayers had significant questions of interpretation.

Rev. Proc. 2021-48

Rev. Proc. 2021-48 addresses one of the primary mechanisms of the PPP. It instructs a taxpayer on how to treat amounts excluded from gross income (tax-exempt income) in connection with the forgiveness of Paycheck Protection Program (PPP) Loans. Under the revenue procedure, taxpayers may treat the tax-exempt income as received or accrued following one of three different approaches: (1) as the taxpayer pays or incurs the eligible expenses; (2) when the taxpayer files an application for PPP Loan forgiveness; or (3) when PPP Loan forgiveness is granted.[6]

Though the income is not taxed, there are still important timing considerations for many taxpayers. The revenue procedure highlights the need for a taxpayer to determine when such tax-exempt income is included in gross receipts under sections 448(c) or 6033 of the Code. Importantly, the IRS has provided a safe harbor that permits taxpayers to exclude PPP-related tax-exempt income from gross receipts when determining eligibility for the employee retention tax credit (ERTC).[7] However, Rev. Proc. 2021-48 allows that taxpayers may also choose to include that income in gross receipts or may need to incorporate that information for other purposes in different code sections.

Taxpayers may report such tax-exempt income under one of these three methods on a timely filed original or amended Federal income tax return, information return or administrative adjustment request (AAR) (or for BBA partnerships, an amended return rather than an AAR as permitted pursuant to Rev. Proc. 2021-50 below).

Rev. Proc. 2021-49

Rev. Proc. 2021-49 provides guidance for partnerships and consolidated groups regarding amounts excluded from gross income and deductions relating to the PPP and a variety of other COVID-19 relief programs. Rev. Proc. 2021-49 covers taxpayers in the following situations:

1. a taxpayer that received a PPP Loan that was fully or partially forgiven;
2. a partnership for which the SBA made payments with respect to a covered loan under § 1112(c) of the CARES Act (i.e. 7(a) loans or 504 loans, or SBA microloans);

[1] Public Law 116-136, 134 Stat. 281 (2020).

[2] 15 U.S.C. 636(a).

[3] CARES Act at § 1102(a)(2) (defining "covered loans" as loans made under the PPP between Feb. 15, 2020 and Dec. 31, 2020); *see also* Paycheck Protection Program Flexibility Act of 2020, Public Law 116-142, 134 Stat. 641 (June 5, 2020) (clarifying deductibility provisions).

[4] CARES Act at 1106(b) ("any amount which [but for PPP provisions] would be includible in gross income of the eligible recipient by reason of forgiveness [through the PPP] … shall be excluded from gross income").

[5] COVID-related Tax Relief Act of 2020 (COVID Tax Relief Act), enacted as Subtitle B of Title II of Division N of the Consolidated Appropriations Act, 2021 (Appropriations Act), Public Law 116-260, 134 Stat. 1182 (Dec. 27, 2020).

[6] *See* section 3 of Rev. Proc. 2021-48.

[7] Revenue Procedure 2021-33, 2021-34 I.R.B. 327.

3. a partnership that received an Emergency EIDL Grant, a Targeted EIDL Advance, or a Shuttered Venue Operator Grant;

4. a partnership that received a Supplemental Targeted EIDL Advance;

5. a partnership that received a Restaurant Revitalization Fund Grant.

To reflect the effects of the various COVID-related exclusions from income and deductions, Rev. Proc. 2021-49 provides guidance on how to allocate certain partnership items, adjust partnership interest basis, or adjust stock basis in consolidated groups. The rules vary by the different programs, so taxpayers should review these provisions to identify their specific circumstances. If a PPP loan is not fully forgiven, a taxpayer must make adjustments on an amended return, information return or AAR, as applicable, for the tax year(s) in which the taxpayer treated tax-exempt income from the forgiveness of such PPP loan as received or accrued.

Rev. Proc. 2021-50

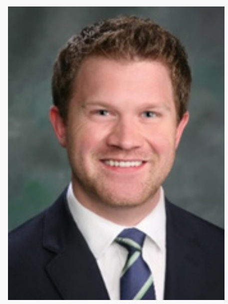
Rev. Proc. 2021-50 allows BBA partnerships to implement the procedures of Rev. Proc. 2021-48 or Rev. Proc. 2021-49 without filing an administrative adjustment request (AAR). Eligible BBA partnerships may file an amended return instead of an AAR. The revenue procedure clarifies, however, that amendment is optional and a partnership may still file an AAR for the same purpose. A BBA partnership that files an amended return pursuant to this revenue procedure is still subject to the centralized partnership audit procedures enacted by the BBA.

To take advantage of the option to file an amended return, a BBA partnership must file a Form 1065 (with the "Amended Return" box checked) and furnish amended Schedules K-1 to its partners. The amended return should state "FILED PURSUANT TO REV PROC 2021-50" at the top, and any amended K-1 should include the same language in a statement. The Rev. Proc. includes additional rules for taxpayers under exam, taxpayers that have already filed AARs, and taxpayers with a BBA partnership as a partner.

Conclusion

After multiple large legislative packages, the IRS continues to issue guidance to help taxpayers interpret and implement the new provisions. With these new revenue procedures, taxpayers have more certainty about the timing and impact of tax-exempt income from PPP loans and similar programs.

ABOUT THE AUTHORS



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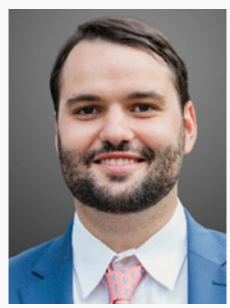

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John is a Manager with RSM's Washington National Tax Office. John works primarily in accounting methods and periods and is an RSM subject matter expert on like-kind exchange and involuntary conversion. John advises taxpayers on a variety of issues in consultative and compliance roles and performs tax law research. John focuses primarily on real estate, tangible property and depreciation, and accounting methods and periods.

After two years of virtual programming, we are pleased to announce the official return to a live, in-person conference! Join AIRA for 4 days of in–depth education that includes two all–day seminars (one of which will be held virtually June 14-15), three keynote presentations, and 17 panel sessions on the latest developments and trends in Bankruptcy and Restructuring.

In addition to its outstanding educational program, AC22 offers a dynamic context to enjoy other benefits of the conference and its setting. Participants can connect with peers and make new contacts during the many networking opportunities and 4 optional excursions that will showcase the best of Cleveland!

Situated on the southern bank of Lake Erie, Cleveland is an important metropolitan center between the eastern and western United States, on the maritime border with Canada. Home to both the Rock & Roll and Pro Football Halls of Fame, Cleveland is known for its vibrant culture, arts, rich modern history, and beautiful parks.

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AC22 delves into a variety of industry topics, giving participants an opportunity to earn up to 31.0 CPE credits, including 1.5 ethics credits. 25.8 CLE credits are estimated, including 1.25 in ethics (based on a 60-minute hour); these are pending and subject to each state's approval and rounding rules.

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AC22 has multiple networking opportunities, including a Young Professionals Reception, breaks, luncheons, and receptions. Join us and embrace the chance to meet potential contacts and colleagues in an inviting and informative atmosphere!

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The Hilton Cleveland Downtown is located within a mile of Playhouse Square and East 4th Street shopping. Guests can unwind in the hotel's indoor pool, fitness center, and top-floor bar with views of Lake Erie. AIRA’s special rate is $209/night if reserved by May 27.

Registration opens in March — check www.aira.org for more information!

AIRA
Distinguished Fellows Program

The AIRA Distinguished Fellows Program was created by AIRA's Board of Directors to recognize significant contributions to the art and science of corporate restructuring. AIRA is accepting nominations for the 2022 Class of Fellows.

Nominations must by submitted by April 15, 2022.

Purpose of Distinguished Fellows Program

- To provide a senior-level status that recognizes AIRA member achievements and contributions to the field of corporate restructuring and to AIRA.
- To distinguish AIRA members who exemplify the highest level of excellence in professional practice and whose contributions have left a significant positive legacy to the profession and the organization.

Nomination Process

Elevation to the status of AIRA Distinguished Fellow is by invitation only through a nominating process which includes:

- Submission of completed forms by any AIRA member, and
- Approval by AIRA's Board of Directors.

AIRA members who meet the following criteria are eligible to be nominated. At the time of nomination, a nominee must:

- Be an AIRA member in good standing for at least 10 years, and
- Have made contributions to the art and science of corporate restructuring and to the AIRA that may be deemed outstanding by AIRA's Board of Directors.

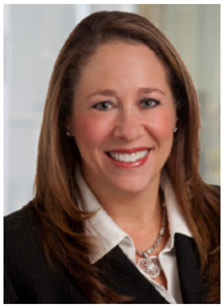
Recognition of Fellows

Upon approval, new Distinguished Fellows will be inducted at the AIRA Annual Conference or at AIRA's New York Plan of Reorganization Conference, and their designation will be included on AIRA's website.

Additional information about AIRA's Distinguished Fellows Program and nomination forms are available at www.aira.org.

AIRA BOARD MEMBER ON THE MOVE

Jennifer Meyerowitz Joins SAK as Chief Growth Officer and General Counsel



Jennifer Meyerowitz has extensive experience in turnarounds, workouts, healthcare advisory services, lease restructurings, real estate transaction services and bankruptcy that spans over 20 years. She has served as an attorney, consultant, investor, advisor, real estate professional and company leader. She is highly regarded within the industry for her operational expertise as well as her unique ability to connect and develop relationships with clients and referral sources.

CIRAS ON THE MOVE

KapilaMukamal LLP Names Mark Parisi and Jaime Angarita as Principals

Mark Parisi, CPA, CIRA, CFE, joined the firm in 2013 and has been promoted to Principal. He previously held the title of Consultant. Mark has extensive experience structuring complex financial models used in forensic accounting and litigation support matters. He has assisted on projects working in conjunction with the FBI, SEC and U.S. Attorneys' Offices. Mark holds an MBA from Nova Southeastern University and a Bachelor of Science in Accounting and Finance from Florida State University.

Jaime A. Angarita, CPA (New York), ABV, CIRA, focuses his practice on commercial litigation and corporate turnaround services including corporate restructuring, business disputes, bankruptcy & liquidation. Fluent in Spanish, Jaime has served in the roles of Financial Advisor, Chief Operating Officer and Deputy Chief Restructuring Officer. He was formerly Director of Restructuring and Dispute Resolution Services Restructuring and Dispute Resolution Service at CohnReznick LLP in New York City. Jaime holds a Master's degree in Accounting from Florida International University and a Bachelors in Accounting & Finance from the University of South Florida.

AIRA GRANT NEWTON EDUCATIONAL ENDOWMENT FUND

OUR MISSION

The AIRA Endowment Fund's mission is to further educational programs and funding of research focused on the areas of accounting, restructuring and insolvency including establishments of scholarships; sponsorships and encouragement of research and educational forums; education of judges, court personnel and governmental and other not-for-profit personnel; and providing other projects, materials or educational benefits to the bankruptcy and insolvency community.

SCHOLARSHIP

Through the generosity of our members, the Endowment Fund has reached a level enabling AIRA to fund a regular scholarship. The AIRA Board of Directors approved its third scholarship funding of $2,500 to an outstanding Pepperdine University accounting student at its January board meeting.

CONTRIBUTE

To make a contribution or pledge online, go to https://www.aira.org/aira/endowment_fund. You may also send a check payable to "AIRA Grant Newton Educational Endowment Fund" by mail to AIRA, 221 W. Stewart Avenue, Suite 207, Medford OR 97501. For more information contact AIRA Controller, Sue Cicerone at scicerone@aira.org.

Contributors of $200 or more will receive a limited-edition Grant W. Newton bobble head, designed to commemorate Grant's retirement after more than three decades of leadership and service to the AIRA and its education program.

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